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Lighten up short duration risk tactically but medium term bearish story still holds

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Overview

- The beginning of the Fed's balance sheet normalization process marks a milestone some nine years after first embarking on QE, but market focus was squarely on changes to the 'dots' that were near-term hawkish but medium-term dovish. We look for a Fed hike in December followed by three hikes in 2018. We update our analysis of yield pickup via foreign bonds; synthetic dollar and euro bonds created via JGBs continue to offer attractive pickup

Euro

- We take profit on 30Y Bund shorts waiting for better entry levels to go short again as medium term drivers are still supportive. Intra-EMU spreads: keep modest widening bias but shift short from 30Y Italy vs. Germany to short 7Y Spain vs. Germany. Italian political developments and the Portugal rally improve the outlook for Italy. Hold OW in Cyprus and (reduced) in Portugal. Special focus: Update on Italian politics. Keep paying Dec19 ECB OIS outright but close Sep18/Mar19 ECB OIS curve steepener. Close short body of Dec18/Dec19/Dec20 50:50 Euribor butterfly. We have a bias to pay 10Y in the 5s/10s/30s 50:50 EUR swap fly. Initiate 2s/5s weighted bear steepener while holding 2s/5s/10s bear belly cheapener. Bullish hedges: hold 3s/30s and reds/blues weighted bull flatteners. Special focus: Money market and benchmark reform, a new index from the ECB. Target 35-36bp in Schatz OIS swap spread to initiate widener. Take profit on Bund OIS swap spread narrower but keep Schatz/Bund swap spread curve flattener. Keep OTM Bund swap spread conditional bull widener. Stay short 112.1/111.9 Dec17 Schatz unhedged strangles. Hold Schatz/Bund vol curve steepener but take small profit in long 10Yx10Y vega. Take profit in long 2Y UST puts versus Schatz

UK

- Shift long Nov17 MPC OIS into Nov17/Feb18 MPC OIS curve steepener. Stay neutral on duration outright and cross market. Keep 10s/30s flattening bias and hold 5Yx5Y/15Yx15Y GBP swap curve flatteners. Sell the belly of the 4T38/3Q44/1H47 cash-and-duration neutral fly. Shift to a 10Y swap spread widening bias. Stay bullish on 10Y implieds, keep 3Mx2s/10s bull steepeners

Scandinavia

- Keep short 5Y Sweden real yield; switch 2s/10s into 1s/5s SEK swap curve steepener. Initiate 10Y SEK swap spread narrower and fronts/greens Nibor curve steepener

Japan

- Hold 7s/10s JGB curve steepener, 5s/10s/30s JGB belly richener, and JGB#22 breakeven widener

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Overview: Lighten up short duration risk tactically but medium term bearish story still holds

- **The beginning of the Fed's balance sheet normalization process marks a milestone some nine years after first embarking on QE, but market focus was squarely on changes to the 'dots' that were near-term hawkish but medium-term dovish. We look for a hike in December followed by three hikes in 2018. We update our analysis of yield pickup via foreign bonds; synthetic dollar and euro bonds created via JGBs continue to offer attractive pickup**
- **In the Euro area, we continue to see higher yields by year end, but turn tactically more cautious. Take profit on short 30Y Germany. Keep paying Dec19 ECB OIS outright as market still under prices our pace of normalization, but tactically close Sep18/Mar19 ECB OIS curve steepener. Enter 2s/5s weighted bear steepener, keep 3s/30s and reds/blues weighted bull flatteners as bullish hedges. Take profit on Bund OIS swap spread narrower. In vol, keep Schatz/Bund vol curve steepener and longs in 10Yx10Y vega**
- **Intra-Euro area, we keep modest widening exposure to Italy (medium term) and Spain (short term). Take profit on short 30Y Italy vs. Germany, but stay short via 13Y Italy vs. Portugal and 5s/10s Italy steepener vs. Spain**
- **In the UK, the BoE appears to have shifted its rhetoric in a non-linear way, and seems intent on delivering a hike over the next few months despite an ambiguous macro backdrop. Shift to Nov17/Feb18 MPC OIS steepener from long Nov17. Stay neutral on 10Y duration, but shift to a widening bias on 10Y swap spreads. In vol, stay long 5Yx10Y vega**
- **In Japan, hold long 10Y JGB inflation breakevens, 7s/10s JGB curve steepeners and longs at the belly of the 5s/10s/20s butterfly**
- **In Scandinavia, stay short 5Y Sweden real yields and enter 10Y SEK swap spread narrowers**

Exhibit 1: G4 bonds continued to sell off this week with the US underperforming after a somewhat more hawkish near term message from the Fed meeting

Changes in b/m yield over the past 1W, by region; bp

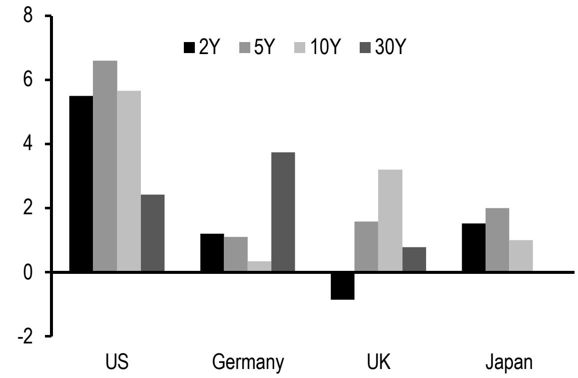

Exhibit 2: The flash PMIs were the main highlight in an otherwise light week on top tier releases

Past 1W data surprises vs. consensus expectations

	Surprise		
Region	**Upside**	**In line**	**Downside**
Euro area	Consumer confidence PMI-mfg PMI-services	CPI	
US	Initial jobless claims Philly Fed	PMI-mfg	PMI-services
UK	Retail sales		
Japan		All industry activity idx	
Australia	House price index		
New Zealand	Current account bal.	2Q GDP	

Note: Jobless claims are reported as upside (downside) surprises if they are lower (higher) than consensus expectations. Inflation expectations are reported as upside (downside) surprises if they are higher (lower) than consensus.
Source: Bloomberg

- **Next week's key events: RBNZ; global consumer confidence, Euro area HICP**

G4 bonds continued to sell off this week (**Exhibit 1**) with the US underperforming after a somewhat more hawkish near term message from the Fed meeting.

The flash PMIs were the main highlight in an otherwise light week on top tier releases (**Exhibit 2**). Both the **Euro area** manufacturing and services PMIs surprised on the upside, bringing the composite measure close to its cycle highs earlier this year. The 3Q17 average of 56.0 is consistent with GDP growth at a 2.6% q/q annualized pace, with the strength in the end of the quarter suggesting the momentum will carry on into 4Q[1].

[1] *Euro area: PMI jumps and we raise our 4Q GDP forecast*, G. Fuzesi, 22 Sep 2017.

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As a result, our economists raise their 4Q forecast by 0.5% to 2.5% q/q.

In the **US**, the activity surveys were more mixed, with a stronger than expected Philly Fed survey, a modest improvement in the manufacturing PMI in line with expectations, and a weaker services PMI[2].

In the **Japan**, real trade indices published by the BoJ suggested strength in net trade, offsetting weak domestic demand that posed a downside risk, leading our economists to keep their forecast for 3Q17 growth at 1.5% q/q annualized[3]

Changes to 'dots' overshadow the Fed's unwind beginning

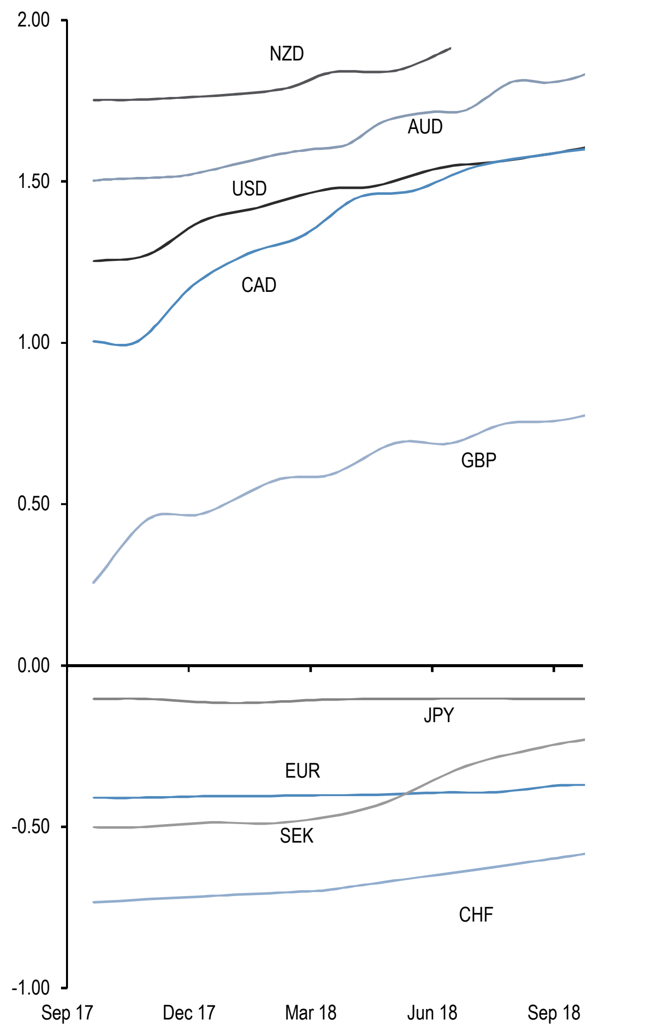
Much of the attention at this week's FOMC meeting was on the changes to the committee's interest rate projections, or 'dots'. The message from was near-term hawkish and medium-term dovish, with the market paying more attention to the former. The fact that there was no increase in the number of participants that look for no hikes beyond the four (out of 16) in the June projections sent a clear signal that the majority continue to see a hike in December despite the weakness in inflation prints for much of the past 6M. This was a modest surprise, as recent Fed commentary had suggested softness in inflation had sowed some doubts. In addition, the median for 2018 still calls for three hikes.

That said, offsetting the near-term hawkish message, the median for 2019 now calls for two hikes rather than three as previously, and the median estimate of the longer-run (or 'neutral') rate also declined by 25bp to 2.75%. Despite the recent sell-off, the market is clearly some way from pricing in anything approaching the 'dots' beyond the end of this year (**Exhibit 4**). We continue to look for a December hike followed by three hikes in 2018.

In addition, the post-meeting statement did not reflect any heightened concerns over the inflation outlook, despite some concerns expressed in the minutes of the previous meeting and in some recent speeches by Fed officials. Indeed, the only substantive change from the previous statement was the acknowledgement of hardships resulting from the recent hurricanes, while observing that they are unlikely to have a material impact on the broader economy over the medium term.

Exhibit 3: Central bank policy rate expectations inferred from money market rates

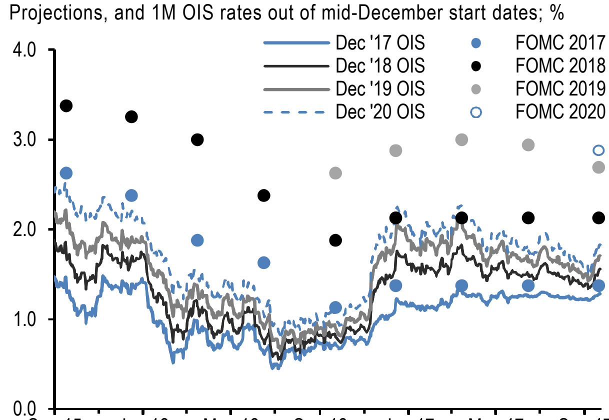
Central bank policy rate expectations: 1M spot OIS rate and 1M forward OIS rates* starting at central bank meeting dates**; %



* Adjusted for the differential between policy rates and O/N OIS rates. For USD OIS, adjusted for the differential between the O/N OIS rate and the upper bound of the Fed funds target range.
** Except CHF, where we use 3M forward swap rates as the SNB targets the 3M Libor rate.
Source: J.P. Morgan

Exhibit 4: Despite the sell-off over the past two weeks, markets are clearly some way away from pricing in anything approaching the 'dots' beyond the end of this year

FOMC projections for the Fed funds rate from the Summary of Economic Projections, and 1M OIS rates out of mid-December start dates; %



[2] US: PMIs mixed in September, J. Edgerton, 22 Sep 2017.
[3] Japan: strong exports offset weak domestic demand, Y. Mera, 20 Sep 2017.

Given the attention focused on the dots, the FOMC's decision to begin its balance sheet normalisation process in October seemed passed without much fanfare. To be fair, it was clearly signalled, but it nonetheless marks a milestone some 9 years after first embarking on QE. The Fed had announced already earlier in the year the pace at which it was going to begin its balance sheet normalisation process – i.e. allowing $6bn of Treasuries and $4bn of MBS to mature each month for the first three months, and then linearly increase the caps by a combined $10bn each quarter until they reach $50bn in 4Q18, where they would be held from there on – but it did further clarify that it would allocate any rollover amounts in proportion to total maturities of securities maturing that month.

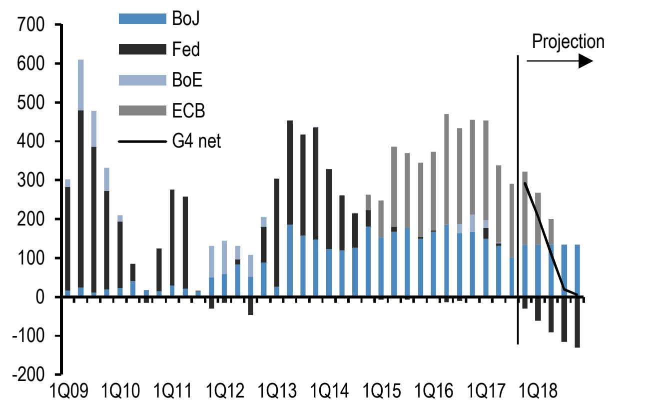
With the confirmation of the Fed's balance sheet unwind the decline of the duration impulse from G4 central banks is set to gather steam in coming quarters. Next month's ECB meeting should reveal at least the broader contours of the its tapering of QE purchases in 2018. We continue to expect an extension of QE for 3M at €40bn/m for 1Q18, before declining to €20bn/m in 2Q and ending the programme in mid-2018, though we acknowledge this is a close call between 3M and 6M extensions. Combined with the reduction from €80bn to €60bn/m that already took place from April 2017 onwards, and the fact that the BoJ appears to have reduced its purchase pace over the past few quarters to around ¥60tn/y in recent quarters, compared to around ¥70tn/y from 3Q16-1Q18 and its stated target of ¥70tn/y, this has already reduced the quarterly G4 aggregate purchase pace from $450bn in 1Q17 to just under $300bn in 3Q17, before declining further to effectively zero by 4Q18.

Dovish surprise at the BoJ, while a snap election looks more likely

The BoJ remained on hold this week with a largely unchanged assessment on its growth and inflation outlook. However, the dissent by Kataoka, who only joined the BoJ Board in July this year, and the dovish tone struck by Governor Kuroda at the post-meeting press conference came as a surprise. Kuroda noted the weakness of the recent inflation trend and hinted at further easing in policy conditions if the BoJ considered it warranted. The bigger surprise was the objection by Kataoka, who asserted that the probability of CPI inflation rising toward 2% from 2018 was low, and that further easing was required to get inflation to its 2% target in FY2019. Our economists do not expect any additional easing from the BoJ as long as inflation

Exhibit 5: The confirmation of the Fed's taper, along with a slowdown in the BoJ's purchase pace, has brought the G4 aggregate quarterly purchase pace from $450bn in 1Q17 to just under $300bn in 3Q, and looks set to decline to zero by end-2018

Quarterly change in the stock of asset purchases by central bank*; $bn**



* Includes MBS and Treasury purchases for the Fed; APP purchases for the ECB, conventional JGBs, inflation-linkers and floating rate bonds for the BoJ and the stock of gilt holdings and corporate bonds for the BoE.
** Past purchases converted to US dollar equivalents using quarter average exchange rates, projections using current exchange rates. Assumes the BoJ's purchase pace continues at a similar pace to recent quarters of around ¥60tn per year, and our ECB and Fed calls as outlined in the text.
Source: ECB, Federal Reserve, BoJ, BoE, J.P. Morgan calculations

remains on an upward trajectory despite the dovish dissent[4].

Separately, various media reports appear to confirm that Prime Minister Abe is set to dissolve the Lower House next week and hold a snap election on 22 or 29 October. An early election was unexpected given geopolitical tensions around North Korea remain elevated, but appears to have been driven by domestic political considerations given the weakness of opposition parties[5]. The economic impact of the election should be limited, but it does increase the likelihood of a continuation of the BoJ's yield curve targeting regime (see *Japan*).

A shift from the Riksbank becomes more likely into year-end

The minutes of the Riksbank meeting earlier this month retained a dovish tone with most board members downplaying the rise in CPIF inflation due to distortions, and the strengthening in the krona triggering significant discomfort. We think the macroeconomic pressures on the Riksbank to begin normalising policy are building, however, and the minutes hinted at two key conditions to be met before it will begin to respond to this pressure: 1)

[4] *BoJ: Kuroda's view tilted slightly towards dovish side*, H. Ugai, 21 Sep 2017.
[5] *Japan: a snap election in October would extend secular longevity of PM Abe*, M. Adachi, 18 Sep 2018.

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it wants to see inflation stabilise for longer, and are comfortable with an overshoot; and 2) the concerns over the currency mean they want to see greater visibility on ECB policy before acting.

Following the abrupt shift in BoE rhetoric last week, we think the potential for a significant shift exists in Sweden as well. However, we think the first meeting where a shift could begin to take place is in December, as the Riksbank will likely want to see a few more inflation prints and its October meeting is the day before the ECB meeting. Our base case remains that the Riksbank will begin to normalise policy rates with a 10bp hike in July next year, but given building macro pressures the risks are tilted towards an earlier hike and/or a steeper path than the around 12-13bp per quarter in the Riksbank's projections after the first hike.

Trading strategy

After the sell-off over the past two weeks, along with a somewhat more hawkish near-term delivery, we turn tactically more cautious on duration. Our US colleagues turned neutral on front-end duration after the FOMC meeting, and we turn neutral on the ultra-long end in Germany. Intra-EMU, keep modest periphery widening exposure to Italy and Spain. Hold front-end longs and curve steepeners in Australia. Cross-market, keep longs in front-end UK vs. Sweden and longs in long-end Australia and front-end NZ duration vs. US.

In the Euro area, we continue to see higher yields by year end, but turn tactically more cautious. Take profit on short 30Y Germany. Keep paying Dec19 ECB OIS outright as market still under prices our pace of normalization, but tactically close Sep18/Mar19 ECB OIS curve steepener. Enter 2s/5s weighted bear steepener, keep 3s/30s and reds/blues weighted bull flatteners as bullish hedges. Take profit on Bund OIS swap spread narrower. In vol, keep Schatz/Bund vol curve steepener and longs in 10Yx10Y vega (see *Euro Cash* and *European Derivatives*).

Intra-Euro area, we keep modest widening exposure to Italy (medium term) and Spain (short term). Take profit on short 30Y Italy vs. Germany, but stay short via 13Y Italy vs. Portugal and 5s/10s Italy steepener vs. Spain (see *Euro Cash*).

In the UK, the BoE appears to have shifted its rhetoric in a non-linear way, and seems intent on delivering a hike over the next few months despite an ambiguous macro backdrop. Shift to Nov17/Feb18 MPC OIS steepener from long Nov17. Stay neutral on 10Y duration, but shift

Exhibit 6: Long-only model portfolio

Yield and modified duration for each country index, benchmark weights and active deviations. For maturity buckets where we express a view, we show yield, modified duration, the amount of the benchmark weight accounted for by each maturity bucket, and the active deviation specific to that maturity bucket

	Yield (%)	Duration	Benchmark weight	Active deviation
GBI US	2.32	6.3	34.2%	
GBI US 1-5Y	1.65	2.7	19.3%	
GBI US 5-10Y	2.11	6.3	8.0%	-2.1%
GBI US 10Y+	2.72	16.6	6.9%	
GBI Japan	0.38	10.1	16.8%	
GBI UK	1.66	11.5	6.1%	
GBI Germany	0.49	7.3	4.7%	
GBI Germany 1-5Y	-0.52	2.8	2.1%	
GBI Germany 5-10Y	0.11	7.1	1.3%	1.2%
GBI Germany 10Y+	0.98	14.8	1.3%	
GBI France	0.89	7.7	6.7%	
GBI France 1-5Y	-0.39	2.7	2.5%	-1.0%
GBI France 5-10Y	0.33	6.7	2.0%	
GBI France 10Y+	1.42	14.5	2.2%	
GBI Italy	2.04	6.7	6.3%	
GBI Italy 1-5Y	0.31	2.8	2.6%	1.3%
GBI Italy 5-10Y	1.55	6.2	1.8%	-0.6%
GBI Italy 10Y+	2.81	12.2	1.9%	
GBI Spain	1.57	6.9	3.8%	
GBI Spain 1-5Y	-0.04	2.6	1.4%	-1.4%
GBI Spain 5-10Y	1.05	6.7	1.3%	-0.8%
GBI Spain 10Y+	2.34	12.8	1.1%	
GBI Belgium	0.99	9.2	1.7%	
GBI Netherlands	0.63	8.1	1.4%	
GBI Denmark	0.62	8.1	0.4%	
GBI Sweden	0.63	6.1	0.3%	-0.3%
GBI Australia	2.78	6.1	1.4%	
GBI Australia 1-5Y	2.18	2.7	0.6%	-0.6%
GBI Australia 5-10Y	2.68	6.5	0.5%	2.2%
GBI Australia 10Y+	3.09	11.0	0.4%	
GBI Canada	2.18	6.7	1.2%	
US TIPS	0.53	8.2	4.6%	
EMU Linkers	-0.13	8.2	2.2%	
UK Linkers	-1.53	23.2	3.2%	
Cash	1.33	0.25	5.0%	1.9%

Benchmark duration	7.9
Portfolio duration	7.9

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to a widening bias on 10Y swap spreads. In vol, stay long 5Yx10Y vega (see *United Kingdom*).

In Japan, a snap election increases the likelihood of a VAT hike, boosting inflation breakevens along with cheap valuations and a favourable supply/demand outlook. Hold long 10Y JGB inflation breakevens, 7s/10s JGB curve steepeners and longs at the belly of the 5s/10s/20s butterfly (see *Japan*).

In Scandinavia, the building macroeconomic pressures combined with Riksbank caution keeps us with a short duration stance. Hold shorts via 5Y Swedish real yields, enter 10Y SEK swap spread narrowers and stay short cross market via Mar18 SEK FRA vs. Short Sterling. (see *Scandinavia*).

Long-only model portfolio

We introduced a global long-only portfolio in mid-September 2015[6] with the aim of implementing our regular trade recommendations in the context of a long-only portfolio without using leverage.

Our recommended portfolio is shown in **Exhibit 6**. We take profit on duration shorts in long-end Germany and front-end US and turn tactically neutral. We retain a modest short in 1-5Y France and in GBI Sweden as proxies for shorts in 5Y French and Swedish real yields. On the curve, we keep 1-5Y/5-10Y Australia flatteners. In the periphery, we shift spread widening exposure to shorts in 5-10Y Spain vs. Germany, and keep 1-5Y/5-10Y Italy steepeners vs. Spain flatteners. Cross-market we hold longs in 5-10Y Australia vs. US. **Exhibit 7** summarizes the deviations from benchmark. The portfolio duration exposure is now largely flat vs. benchmark.

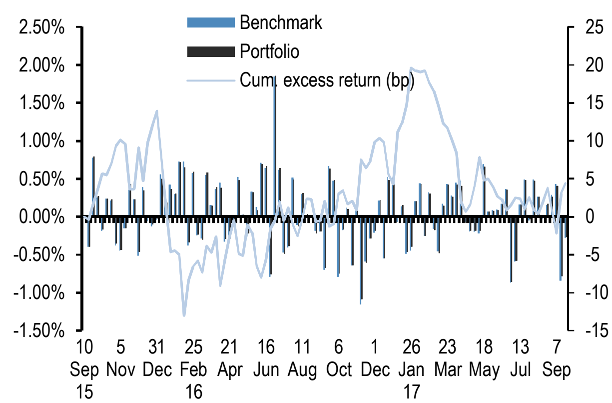
Our portfolio outperformed the benchmark modestly this week (**Exhibit 8**) due to gains from outright duration shorts (**Exhibit 9**).

We take as our starting point a benchmark portfolio comprising of around $24tn of government bonds, comprising of conventional government bonds in the JPM GBI Global index as well as our inflation-linked bond indices for US TIPS, Euro area linkers (ELSI) and UK linkers (GILLI). We then overlay this benchmark portfolio with active deviations from benchmark to reflect the tactical themes discussed above and in each of the sections in GFIMS in terms of duration, curve and cross-market allocation. The net residual position from

Exhibit 7: Summary of model portfolio deviations vs. benchmark
Deviations from benchmark in outright duration, curve and cross-market positions, expressed in broader country indices or specific maturity buckets where specified

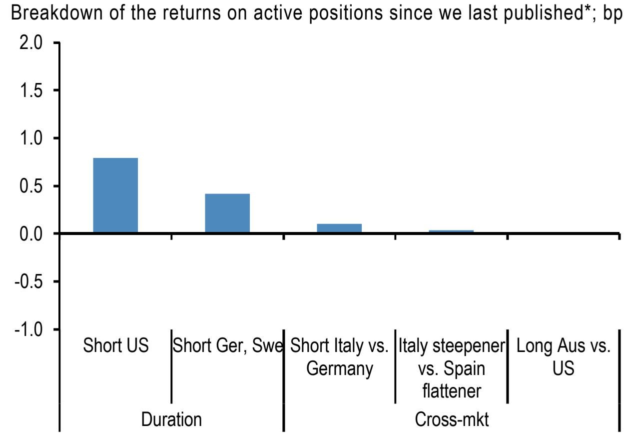
	Duration	Curve	Cross-market
US			Short 5-10Y vs. Aus
UK			
Japan			
EA core	UW 1-5Y France		Long 5-10Y Germany vs. Spain
EA periphery		1-5Y/5-10Y Italy steepener vs. Spain flattener	Short 5-10Y Spain vs. Germany
Sweden	UW		
Australia		1-5Y/5-10Y flattener	Long 5-10Y vs. US
Inflation			

Exhibit 8: Our portfolio outperformed the benchmark modestly this week...
Weekly total return on the benchmark and our model portfolio (lhs, %), and the cumulative excess return on our model portfolio over the benchmark (rhs, bp); data up to close of business 21 Sep 2017*



* We show weekly returns from Thursday to Thursday for consistency

Exhibit 9: ... due to gains from outright duration shorts
Breakdown of the returns on active positions since we last published*; bp



* Data up to close 21 Sep

[6] *Overview, GFIMS*, 11 September 2015.

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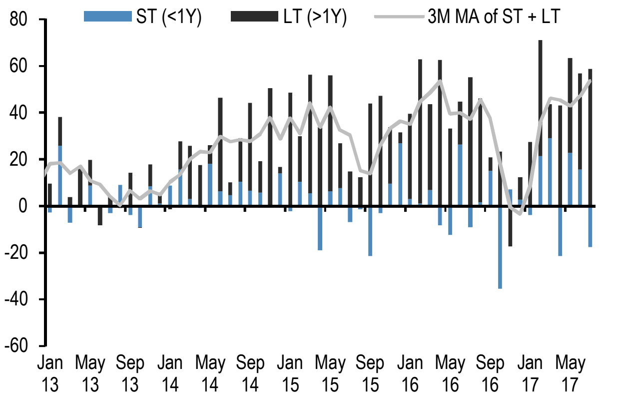
Exhibit 10: Euro area residents bought €60bn of foreign bonds with >1Y maturities in July, continuing on the recent strong trend on outflows despite the decline in the ECB's purchase pace…

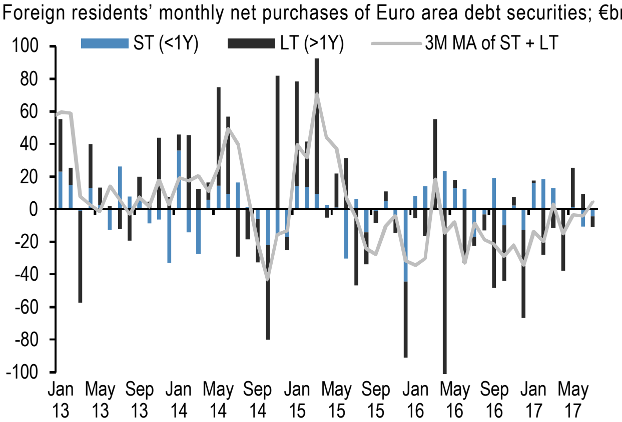
Euro area residents' monthly net purchases of foreign debt securities; €bn



Source: ECB

Exhibit 11: …while foreign investors' net purchases of Euro area bonds have remained very modest

Foreign residents' monthly net purchases of Euro area debt securities; €bn



Source: ECB

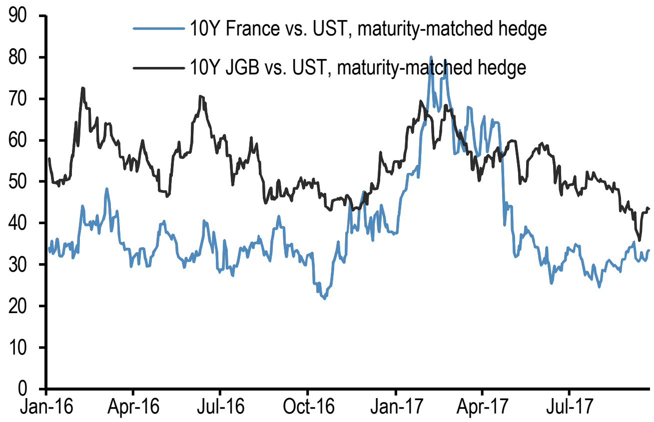
duration-neutral curve trades is placed in cash (return of 3M USD Libor). For some countries, as well as curve trades via GBI maturity buckets, the maximum size of trades may be restricted by the benchmark weight.

Outflows from Euro area residents to foreign bonds remain heavy

The Euro area Balance of Payments data for July revealed that Euro area residents remained heavy buyers of foreign bonds (**Exhibit 10**). Indeed, while the total outflow into foreign debt securities declined somewhat to €40bn in July, compared to around €60bn in May and June, the flows into debt securities with greater than 1Y maturities rose sharply to nearly €60bn compared to around €40bn in the preceding three months. So despite the decline in the ECB's purchase pace in April, the pace

Exhibit 12: …as are synthetic longer-end dollar denominated securities via OATs and JGBs

Yield pick-up* of 10Y JGBs and OATs vs. USTs with maturity-matched currency hedges; bp



* See footnote for Exhibit 16 below for calculation methodology.

Source: J.P. Morgan

of foreign bond purchases has picked up meaningfully, bringing total outflows into foreign bonds since March 2015 to around €1tn, or around half of the ECB's cumulative QE purchases of €2tn.

By contrast, foreign investors net purchases of Euro area bonds remain relatively muted (**Exhibit 11**). They sold on net around €10bn of Euro area bonds in July, compared to broadly flat purchases in June, with the sales broadly equally split between shorter term (<1Y) and longer term (>1Y) bonds.

Opportunities for yield pick-up via foreign bonds

We update on developments in the yield pick-up available for investors via foreign bonds, presented in the regular table in **Exhibit 16** below. The analysis compares the yield pickup at different benchmark maturities on a currency-hedged basis, using 3M and maturity-matched currency hedges, as well as a currency-unhedged basis. As we update the table in each publication for our readers, we focus here on recent changes given the shifts in yields across countries.

Synthetic dollar and euro-denominated bonds created via buying front-end JGBs and hedging the currency risk to maturity **continue to offer an attractive pickup relative to domestic front-end bonds**. The pickup for dollar based investors is currently around 65bp, and while it has declined from around 90bp earlier in this year the synthetic yield at 2.1% remains attractive compared to 2Y Treasuries offering 1.4%. For euro-

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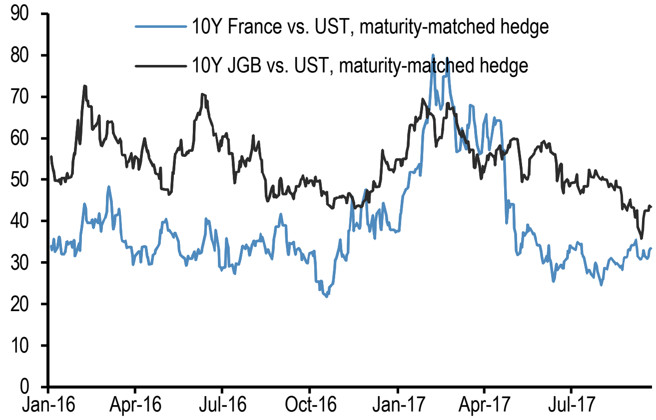
based investors JGBs offer around a 55bp advantage over 2Y Germany, and while this leaves the synthetic yield in negative territory at -17bp it remains modestly above 2Y BTPs at -22bp.

While other opportunities for yield pick-up via foreign bonds are relatively more modest for euro-based investors, **Euro area bonds in addition to JGBs continue to offer a pickup to dollar-based investors** via creating synthetic domestic currency securities via hedging the currency risk to maturity. The advantage has diminished somewhat, on a combination of a less negative cross-currency basis compared to the beginning of the year and in the case of France also on reversal of the previous cheapening of OATs in ASW following the French election, but continue to offer around 30-40bp at 10Y maturities. **Indeed, the combination of the Fed's balance sheet normalization and further Fed hikes will likely drive further USD scarcity and more negative cross-currency bases vs. the dollar**[7], likely increasing the yield pickup available from foreign bonds on a maturity-matched basis.

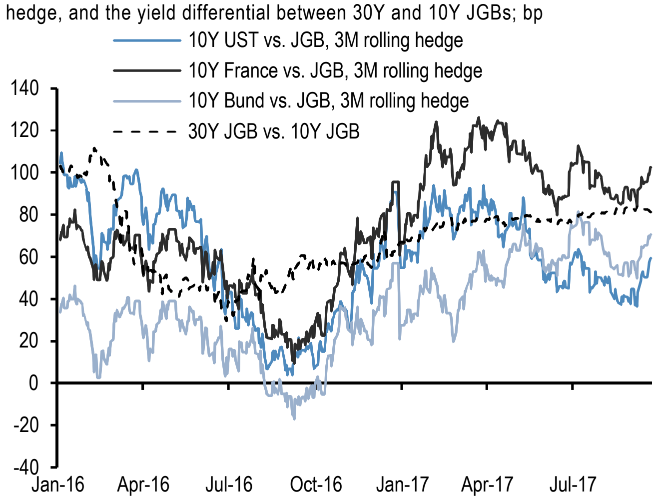
For yen-based investors, foreign bonds continue to offer a yield pickup largely on a rolling currency hedge basis, with the exception of the Euro area periphery. Indeed, French bonds in particular continue to offer around 100bp of pickup at 10Y maturities over JGBs, not far from April peaks at around 110bp, and in excess of the 80bp of pickup available from taking more duration risk by moving further out the domestic curve to 30Y JGBs. The attractiveness of 10Y Bunds has increased since the beginning of the year and offer around 70bp of pickup, largely due to the rise in 10Y Bund yields, while the attractiveness of USTs has moderated somewhat to around 50bp from around 90bp earlier in the year as front-end USD swap rates have risen relative to UST yields given two Fed hikes and a modest decline in 10Y yields.

Exhibit 13: ...as are synthetic longer-end dollar denominated securities via OATs and JGBs
Yield pick-up* of 10Y JGBs and OATs vs. USTs with maturity-matched currency hedges; bp



* See footnote for Exhibit 16 below for calculation methodology.
Source: J.P. Morgan

Exhibit 14: For yen-based investors, 10Y OATs continue to offer an attractive pickup, while the pickup from 10Y Bunds has increased since the start of the year as yields have risen
Yield pick-up* of 10 USTs, OATs and Bunds vs. JGBs with 3M rolling currency hedge, and the yield differential between 30Y and 10Y JGBs; bp



* See footnote for Exhibit 16 below for calculation methodology.
Source: J.P. Morgan

Next week's key events

Monetary policy: In the **US**, **Fed Chair Yellen** speaks on Tuesday. In **Japan**, the **Minutes of Jul 19-20 BoJ Monetary Policy Meeting** are published Tuesday, **governor Kuroda** speaks on Thursday, and the **Summary of Opinions at Sep 20-21 BoJ Monetary Policy Meeting** is published Friday. In **New Zealand**, we expect the **RBNZ** to stay on hold on Thursday.

Economic data: In the **US**, **consumer confidence** as well as the **Philadelphia Fed nonmanufacturing survey** are out Tuesday. **GDP**, **advance economic indicators** and the **KC Fed survey** are released Thursday, and **personal income**, **consumer sentiment** and the **Chicago PMI** are reported Friday.

In the **Euro area**, the **German IFO** is out Monday. **EC consumer confidence** and **economic sentiment**, **German CPI** and **GfK consumer sentiment**, as well as **Spanish CPI** are all reported Thursday. **Flash HICP**,

[7] *Cross-currency basis 4Q Outlook: Fed b/s reduction and more Fed hikes priced in likely to drive USD scarcity and more negative cross currency basis*, F. Bassi et al, 30 Aug 2017.

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Exhibit 15: Highlights from recent publications with hyperlinks

	Recent publications	Date
Europe	Update on the repo market in Euro ahead of QE tapering: Further balance sheet netting reduces systemic funding pressure but QE-driven German scarcity will persist	21-Sep
	European Client Survey	21-Sep
	Covered Bond Cross-Asset Outlook: September 2017	20-Sep
	Liquidity in EGB secondary markets: Bending but not breaking	18-Sep
	The UK long end view: Enter 5Yx5Y/15Yx15Y swap curve flatteners and 10s/30s real yield curve flatteners given valuations and seasonal dynamics	13-Sep
	ECB QE: less Germany, more France & Italy	04-Sep
	How will rates markets react to the ECB delivery?	04-Sep
	Results of ECB Expectations Survey - September 2017	01-Sep
	ECB QE, what next?	01-Sep
	€-SSA Sep-17 outlook: turn UW on supply & QE tapering	31-Aug
	Cross currency basis 4Q17 Outlook: Fed b/s reduction and more Fed hikes priced in likely to drive USD scarcity and more negative cross currency basis	30-Aug
US	The Fed giveth, and the Fed taketh away: The longer-run impact of normalizing monetary policy on funding markets	20-Sep
	U.S. Treasury Client Survey	15-Sep
	Groundhog Day: What a short-term suspension of the debt ceiling means for USD funding trades	01-Sep
	ICYMI: Highlights from recent publications on the debt ceiling and a government shutdown	31-Aug
	The economics of the impending fiscal battles	29-Aug
	Still a dribble, not a flood: The impact (or lack thereof) of repatriation on FX and fixed income markets	25-Aug
Japan	Japan Rates Topics: JSDA JGB Transaction August: limited buyers even in a risk-off environment	19-Sep
	Japan Flows in Pictures: September 2017	08-Sep
Australia & New Zealand	Antipodean housing markets: A snapshot - September 2017	18-Sep
	Antipodean Vol Monthly: Front-end short positioning appears stretched, scope for a low-vol grind lower into year-end	11-Sep
Inflation	Monthly Inflation Outlook: Onwards and upwards – turning bullish on global inflation breakevens	20-Sep
	Global Inflation Biweekly: Enter 10s/30s RPI swap curve flatteners; Spanish linker auction preview	06-Sep
Previous GFIMs	Global Fixed Income Markets Weekly: The BoE talks the talk, close shorts in UK duration but stay bearish in EUR	15-Sep
	Global Fixed Income Markets Weekly: Keep shorts in Europe given rich valuations as the US shifts back into focus	08-Sep
	Global Fixed Income Markets Weekly: Short duration in 30Y Bund and 10Y gilt on valuations, but don't count on the ECB	01-Sep

German retail sales, **French CPI** and **Italy CPI** are released Friday.

In the **UK**, the **EC consumer confidence** is out Thursday, and both **Gfk consumer confidence** and **GDP** are released Friday.

In **Sweden**, **consumer confidence** and the **Economic Tendency Survey** are out Wednesday, and **retail sales** are reported Thursday.

In **Norway**, **AKU unemployment** is out Wednesday, and both **retail sales** and the **Labor directorate unemployment** are reported Friday.

In **Japan**, the **preliminary manufacturing PMI** is out Monday, and **CPI**, **unemployment, IP** and **retail sales** are released Friday.

Finally, in **New Zealand NBNZ consumer confidence** is out Tuesday.

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Exhibit 16: Yield pickup available via foreign bonds by country and investor currency, on a currency-hedged basis (3M rolling and maturity-matched hedges) and unhedged

Annualized yield pick-up* for euro-, yen-, US dollar- and sterling-based investors from foreign currency bonds vs. domestic bonds (German bonds for euro-based investors) of the same maturity, with no hedge, 3M rolling** and maturity-matched*** currency hedges; shaded regions for rolling and maturity-matched hedges show >1% yield pickup (darkest shading), between 0.5% and 1%, and between 0% and 0.5% (lightest shading); %

EUR-based	US			Japan			UK			Australia			Sweden			Other Euro area^	
FX hedge:	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	France	Italy
2Y	2.16	0.23	-0.11	0.58	0.29	0.54	1.15	0.30	-0.05	2.68	0.29	-0.08	0.02	0.10	-0.14	0.17	0.61
5Y	2.18	0.25	0.00	0.18	-0.11	0.53	1.05	0.20	-0.11	2.69	0.30	-0.23	0.26	0.34	-0.26	0.13	1.18
10Y	1.82	-0.11	-0.01	-0.41	-0.71	0.42	0.94	0.08	0.07	2.36	-0.03	-0.40	0.40	0.48	-0.37	0.32	1.72
30Y	1.51	-0.43	0.32	-0.43	-0.72	0.69	0.67	-0.18	0.48	2.32	-0.07	0.20	0.28	0.37	-0.32	0.56	2.07

^ Pickup relative to Germany

JPY-based	US			Germany			France			Italy			UK			Australia			Sweden		
FX hedge:	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched
2Y	1.58	-0.06	-0.65	-0.58	-0.29	-0.54	-0.41	-0.11	-0.37	0.04	0.33	0.07	0.57	0.01	-0.59	2.10	0.00	-0.62	-0.56	-0.18	-0.68
5Y	2.00	0.36	-0.53	-0.18	0.11	-0.53	-0.05	0.24	-0.39	1.00	1.29	0.65	0.87	0.31	-0.64	2.51	0.41	-0.76	0.08	0.45	-0.78
10Y	2.23	0.59	-0.43	0.41	0.71	-0.42	0.74	1.03	-0.10	2.13	2.42	1.30	1.35	0.79	-0.35	2.77	0.67	-0.82	0.81	1.19	-0.79
30Y	1.93	0.29	-0.37	0.43	0.72	-0.69	0.98	1.27	-0.14	2.49	2.79	1.38	1.10	0.54	-0.21	2.74	0.65	-0.50	0.71	1.08	-1.01

USD-based	Japan			Germany			France			Italy			UK			Australia			Sweden		
FX hedge:	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched
2Y	-1.58	0.06	0.65	-2.16	-0.23	0.11	-1.99	-0.05	0.28	-1.55	0.39	0.72	-1.01	0.07	0.06	0.52	0.06	0.03	-2.14	-0.13	-0.03
5Y	-2.00	-0.36	0.53	-2.18	-0.25	0.00	-2.05	-0.11	0.14	-1.00	0.93	1.18	-1.13	-0.05	-0.11	0.51	0.05	-0.23	-1.92	0.09	-0.26
10Y	-2.23	-0.59	0.43	-1.82	0.11	0.01	-1.50	0.43	0.33	-0.10	1.83	1.73	-0.88	0.20	0.08	0.54	0.08	-0.39	-1.42	0.59	-0.36
30Y	-1.93	-0.29	0.37	-1.51	0.43	-0.32	-0.95	0.98	0.23	0.56	2.49	1.74	-0.84	0.24	0.16	0.81	0.35	-0.13	-1.22	0.79	-0.64

GBP-based	US			Germany			France			Italy			Japan			Australia			Sweden		
FX hedge:	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched	None	Rolling	Maturity-matched
2Y	1.01	-0.07	-0.06	-1.15	-0.30	0.05	-0.98	-0.13	0.22	-0.54	0.32	0.66	-0.57	-0.01	0.59	1.53	-0.01	-0.03	-1.13	-0.20	-0.09
5Y	1.13	0.05	0.11	-1.05	-0.20	0.11	-0.92	-0.06	0.24	0.13	0.98	1.29	-0.87	-0.31	0.64	1.64	0.10	-0.12	-0.79	0.14	-0.15
10Y	0.88	-0.20	-0.08	-0.94	-0.08	-0.07	-0.61	0.24	0.25	0.78	1.64	1.65	-1.35	-0.79	0.35	1.42	-0.12	-0.47	-0.54	0.40	-0.44
30Y	0.84	-0.24	-0.16	-0.67	0.18	-0.48	-0.11	0.74	0.07	1.40	2.25	1.58	-1.10	-0.54	0.21	1.65	0.11	-0.29	-0.39	0.55	-0.80

* Yield pick-up defined as foreign currency yield – hedge cost – domestic currency yield, using par govie curves (except Sweden, where we use benchmark bonds).
** Cost of 3M rolling hedge defined as 3M FX cross-currency basis + domestic 3M swaprate (3s curve) – foreign-currency swaprate (3s curve).
*** Cost of maturity-matched hedge defined as the maturity-matched FX cross-currency basis + domestic swaprate (3s curve) – foreign-currency swaprate (3s curve).
Levels as at COB 21 Sep 2017.
Source: J.P. Morgan

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Exhibit 17: Current Global Rates trade recommendations

Changes are in bold, high-conviction trades are starred (★). All other recommendations are moderate-conviction

	Duration	Curve	Swap spreads	Swap spread curve	Gamma	Vega	Inflation	Cross-market
Euro area	**Bearish bias** Pay Dec19 ECB OIS	6s/30s steepening bias **2s/5s wtd bear steepener** ★ 3s/30s wtd bull flattener Reds/Blues wtd bull flattener 2s/5s/10s bear belly cheapener	Dec17 OTM Bund bull widener Receive 2Yx2Y EUR/USD cross currency basis Reds/5Yx5Y EUR/USD xccy basis curve steepener	Dec17 Schatz/Bund flattener	Sell 112.1/111.90 Dec17 Schatz unhedged strangle ★ Schatz/Bund vol curve steepener	Bullish 15Yx15Y A/A+50 payer spread	10s/30s HICP swap curve steepener Long 5Yx5Y HICP swaps Short 5Y France RY	Short 7Y Spain vs. Germany Long 5Y Cyprus vs. Germany ★ Short 5Y Belgium vs. Finland Long 30Y Austria vs. Netherlands Long 7Y Finland vs. France Long 8Y Ireland vs. France Long 1Y Ireland vs. Finland 5s/10s Italy steepener vs. Spain Short 10Y EIB vs. swaps 10s/30s EFSF steepener vs. Germany Long 3Y EFSF vs. France Long 4Y KfW vs. Belgium
UK	**Nov17/Feb18 MPC OIS steepeners** 15Yx20Y ATMF/ ATMF+50 payer spread	2s/10s bull steepener ★ 5Yx5Y/15Yx15Y swap curve flattener 5s/10s bull steepeners	**10Y widening bias**	30s/50s flattener 2s/10s GBP/USD xccy curve steepener	Buy OTM payers vs selling OTM receivers in 3Mx2Y	Long 5Yx10Y	**Long 5Y RPI swap** 10s/30s RPI flatteners	
Japan*	Neutral	★ JGB 5s/10s/20s belly richener 7s/10s JGB steepener	Neutral				Long JGB #22 breakevens	
Australia / New Zealand*	Rec 6Mx1Y AUD swap	★ Rec NZD 1s/4s 1Y fwd ACGB 10s/20s steepener Buy TCV-28s vs. SAFA-21s Sell QTC-21s vs. TCV-28s Rec AUD 1Yx1Y vs. 1Y and 2Yx1Y Rec NZD 5Yx5Y vs. 2Yx2Y hedged with 5s/10s steepeners Sell ACGB Apr-25s vs. Apr-20s and Apr-26s AUD 3s/10s flattener Sell ACGB May-21s vs Nov-20s and Apr-23s	★ Buy NZGB 2027s on ASW	Pay AUD 10Y swap spreads vs. 3Y swap spreads	Buy 1x AUD 6Mx1Y rec. vs. sell 2x 2Mx1Y rec. 1Y 2s/10s zero cost conditional steepeners Sell AUD 6Mx10Y vs. USD 6Mx10Y ATMF straddles Buy 6Mx1Y receiver spreads	Sell AUD 2Yx3Y ATMF straddles vs. 1Yx1Y ATMF receivers Own 6Mx10Y ATMF straddles vs. 6Mx1Y ATMF straddles	ACGBi 2020 vs. 2030 breakeven steepener	Rec AUD 5Yx5Y vs. NZD 5Yx5Y ★ Pay NZD/USD 7Y cross currency basis swap ★ Rec NZD 1Yx1Y swap vs. USD 1Yx1Y swap Buy ACGB 10Y bonds vs. UST 10Y notes Rec AUD 2Y swap vs. NZD 2Y swap Receive AUD/USD 1Y x-ccy basis vs. NZD/USD x-ccy basis Buy NSWTC 2021s vs. QTC 2022s
Scandinavia	Short bias in Sweden	**1s/5s SEK swap curve steepener** **Fronts/Greens Nibor curve steepener**	**10Y SEK narrower**	Neutral			Short 5Y RY	

* As of 15 September

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Exhibit 18: 2017 trade performance summary

Hit rate* and average P/L** for all trades closed in 2017; bp of yield**

Region	Sector	Trades (#) total	pos	neg	flat	Hit rate*	Avg. PL**
Euro Cash	Overall	107	92	15	0	86%	7
	Duration	6	6	-	-	100%	7
	Curve	6	5	1	-	83%	4
	Country selection / RV	67	57	10	-	85%	8
	SSA	9	8	1	-	89%	6
	Miscellaneous***	1	1	-	-	100%	4
	Inflation	18	15	3	-	83%	5
Euro Derivatives (swaps and spreads)	Overall	80	58	7	15	89%	1
	Duration	5	5	-	-	100%	4
	Curve	16	13	2	1	87%	1
	Conditional curve / flies	17	9	3	5	75%	0
	Swap Spreads	31	24	2	5	92%	1
	Miscellaneous	11	7	-	4	100%	4
Euro Derivs (options)	Overall	32	23	8	1	74%	0
	Options (outright)	23	17	5	1	77%	0
	Options (relative)	7	4	3	-	57%	-1
	Options (money market)	2	2	-	-	100%	2
UK	Overall (ex. options)	81	54	23	4	70%	1
	Duration	12	6	6	-	50%	-3
	Curve	19	13	6	-	68%	1
	Swap Spreads	5	4	1	-	80%	1
	RV	15	9	5	1	64%	0
	Conditional curve / flies	11	6	4	1	60%	-2
	Inflation	19	16	1	2	94%	7
	Options	11	6	5	-	55%	-13
Scandi	Overall	27	18	7	2	72%	0
	Duration	5	4	1	-	80%	-2
	Curve	17	13	2	2	87%	3
	Country selection / RV	5	1	4	-	20%	-8
	Inflation	-	-	-	-	-	-
Japan	Overall (ex. options)	7	5	2	-	71%	4
	Duration	-	-	-	-	-	-
	Curve	1	1	-	-	100%	6
	Country selection / RV	-	-	-	-	-	-
	Swap Spreads	1	1	-	-	100%	12
	FX Basis	3	1	2	-	33%	-2
	Inflation	2	2	-	-	100%	8
	Miscellaneous	-	-	-	-	-	-
	Options	1	1	-	-	100%	1
Australia and New Zealand	Overall (ex. options)	44	37	7	-	84%	7
	Duration	2	2	-	-	100%	10
	Curve	11	9	2	-	82%	10
	Country selection / RV	29	24	5	-	83%	5
	CDS	-	-	-	-	-	-
	Inflation	2	2	-	-	100%	14
	Options	8	8	-	-	100%	15

* Hit rate defined as # positive trades / (total # trades - trades closed at flat).
** Avg. P/L across total # trades. Options trades are shown in bp of notional, except for money market trades which are shown in bp of yield and not included in avg P/L calculation.
*** Previously called CDS
Source: J.P. Morgan.
Note: For individual trade performance data, please see Global Fixed Income Markets Weekly: Trade Statistics, Fabio Bassi et .al, 22 September 2017.

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Euro Cash

- **We tactically take profit on 30Y Bund duration shorts**
- **We still project higher rates by year-end but wait for any pullback to re-enter bearish trades**
- **We favour shorts in 30Y and 6s/30s curve steepeners, but the best bearish curve proxies from a carry and slide point of view are losing directionality**
- **Intra-EMU: keep a medium term modestly negative outlook on Spain (short-term) and Italy (medium-term) and continue to favour Portugal and Cyprus**
- **In periphery we enter short 7Y Spain vs. Germany, close short 30Y Italy vs. Germany but stay UW via long low-coupon and OW CCTeus vs. BTPs; hold OW 13Y Portugal vs. Italy and 5Y Cyprus vs. Germany**
- **Periphery RV: 2Y and 4Y BTPs dear and 3Y BTPs cheap; BTP Sep44/Mar47 too steep; Bono Apr24 dear**
- **Core: hold shorts in 5Y Belgium vs. Finland and 7Y France vs. Finland, longs in 30Y Austria vs. the Netherlands, 5Y Netherlands cheap, OAT Mar21 cheap and Oct25 dear**
- **Supply: light week, around €10bn from Germany and Italy**
- **Special focus I: Italian politics update**
- **Special focus II: Summer brings non-domestics back to Italy**

Where is the next leg of the sell off coming from?

We recommend taking tactical profit on 30Y Bund duration shorts but we keep a medium term bias for higher rates. A variety of drivers has broadly supported our bearish view over the past two weeks, but given how much the rates market has struggled to sustain a sell off this year (**Exhibit 1**) we turn tactically more cautious.

In this section we revisit the drivers of the market.

Exhibit 1: The rates market has struggled to sustain a sell off this year

10Y German benchmark yield; %

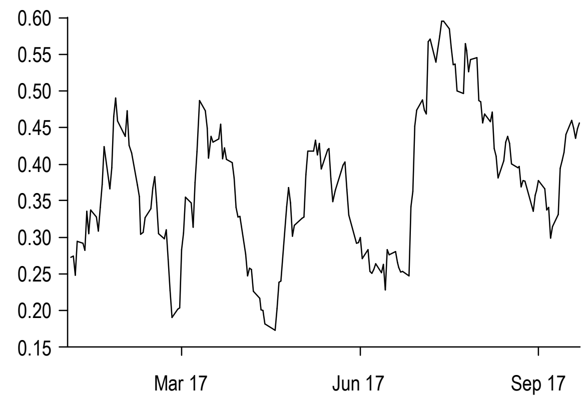
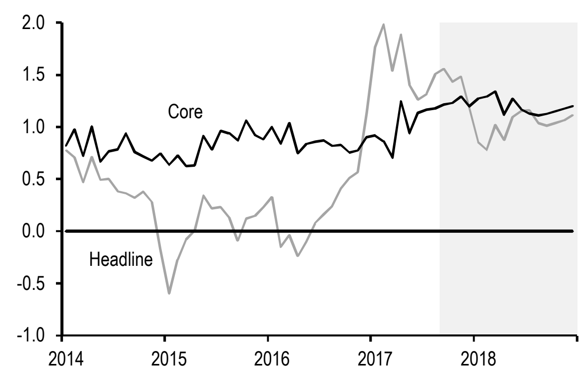


Exhibit 2: We expect a fairly flat core inflation trajectory for the next few quarters

Euro area HICP inflation; %oya; shaded area is forecast



Source: Eurostat and J.P. Morgan

Economic activity

All good but is there room for further surprises? In the Euro area the flash PMIs unwound the recent decline and prompted an upward revision to our 4Q17 growth forecast from 2% to 2.5%q/q[8]. In the US the recent newsflow reduces fears that the economic outlook is weakening and our economics team keeps stressing the positive outlook for EM.

Inflation outlook

We still see the potential for some bearish pressure coming from the inflation outlook. The main justification for the low level of interest rates is scepticism about the transmission from solid growth to reflation. Unfortunately the recent currency strength is likely to mask any improvement in underlying inflation in the Euro area: we expect fairly a flat core inflation

[8] See *Euro area : PMI jumps and we raise our 4Q GDP forecast*, G. Fuzesi, 22 September 2017.

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trajectory for the next few quarters (**Exhibit 2**). The recent rebound in US core inflation is reassuring but there is still room for the core goods inflation subcomponent to rebound given currency developments. On the other hand we do not expect oil to maintain the upward trend it has shown so far in September, but we see only a modest decline as the most likely future path. The inflation outlook is key: **overall we believe that lack of a clear inflation reflation story is likely to hamper any large repricing in global bond yields, hence our forecast for a relatively muted sell off**.

Central bank

We believe market participants misunderstood this week's leaks regarding the ECB future actions.[9] We see the recent rhetoric from the hawks within the Governing Council as certainly consistent with a more aggressive tapering than consensus €40bn for 6M. In general markets have partly readjusted their expectations about future monetary policy tightening but there is scope for further adjustment. For details on the expected reaction to different ECB policy actions see *How will rates markets react to the ECB delivery?*.

Other policymaking

We are not very optimistic about a renewed reform effort in the Euro area following the likely Merkel re-appointment[10] and coalition talks in Germany might take a few weeks so we discount this driver. Similarly in the US the bar for substantive action seems high, but probably market expectations are equally subdued. As usual it is extremely difficult to pre-position for geopolitical risk: our strategy remains to fade any flight-to-quality.

Valuations

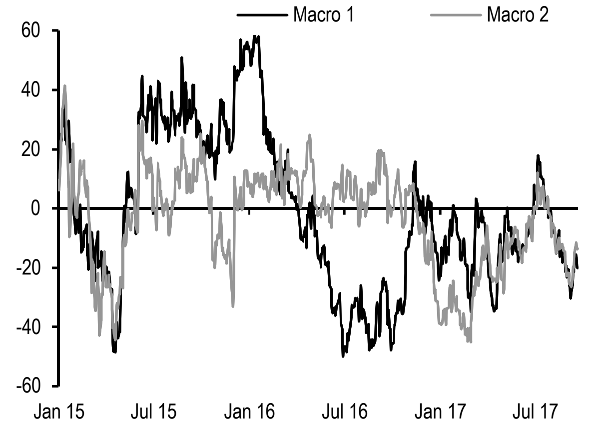
Our valuation models show that the 10Y Bund yield is still expensive at these levels (**Exhibit 3**) based on macro variables. In addition, relative to monetary policy expectations the 10Y Bund yield is too low[11], probably incorporating an excessive scarcity premium.

Positions

Overall position analysis mildly supports a bearish duration stance. Our client surveys shows that duration positions among real money investors are quite light (close to neutral, **Exhibit 4**), even though actual

Exhibit 3: Bund yields are trading on the expensive side

Residual from *1)* 10Y Bund fair value macro model 1*, *2)* 10Y Bund fair value macro model 2** and; bp



* 10Y Bund fair value macro model 1: 0.02*Brent + 0.38*Core HICP + 0.04*Composite PMI – 2.9; R-squared: 85%.

** 10Y Bund fair value macro model 2 = 1.71*5Y 5Y HICP – 1.72. Coefficients on core HICP and PMI from regression above.

Exhibit 4: Duration positions among real money investors are quite light based on our survey

Deviation from EUR duration benchmark of single-currency and multi-currency portfolios; J.P. Morgan European client survey; years

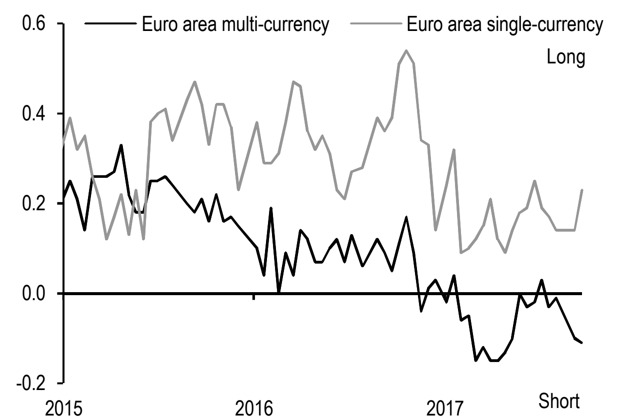
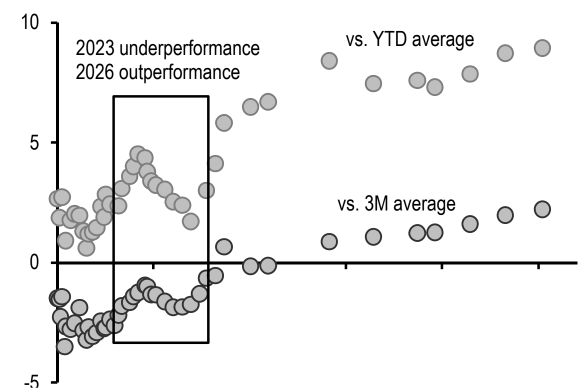


Exhibit 5: German bond yields are struggling to move away from averages

21 Sep cob levels vs. YTD and 3M average; bp



[9] https://uk.reuters.com/article/uk-ecb-policy-bonds/ecb-seen-keeping-option-to-prolong-bond-buying-again-in-2018-sources-idUKKCN1BU1G6

[10] Our colleague in Economics research, Greg Fuzesi, has written extensively on the German vote.

[11] The residual of the model last discussed in Euro Cash, 14 July, is 26bp.

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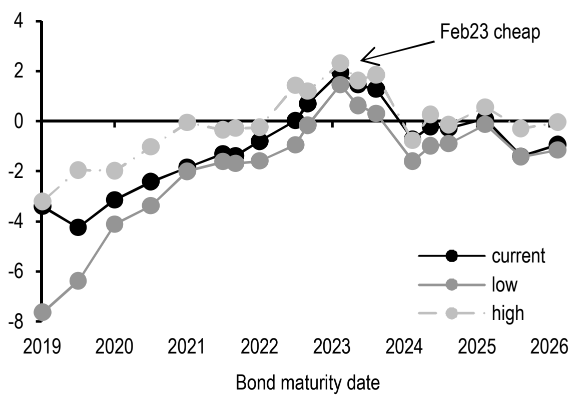
Exhibit 6: 1Y German flies have shown very limited mean reversion apart from the very short end of the curve

1Y Bund flies on the Bund curve*; statistics since Bund Aug27 issuance; bp



* Linearly adjusted when the wing span is different from 1Y.

conversations with clients highlight a short duration bias. On the other hand as highlighted last week, our estimate of CTA duration exposure remains close to the early June highs.[12]

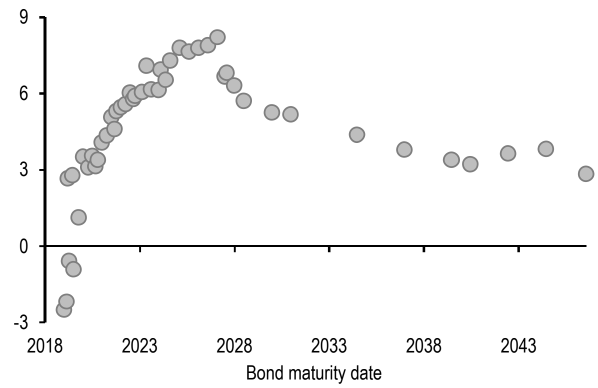
Germany trade ideas

German yields inched higher broadly in parallel on the week. Comparing the current level of yields with the YTD and past 3M average a few features emerge (**Exhibit 5**):

1) The curve has generally steepened; 5s/30s and 10s/30s steepeners would have also been supported by positive carry.
2) 2023 bonds underperformed on the curve whereas 2025 and 2026 bonds outperformed. RV-wise 2023 and 2024 bonds are looking cheap (**Exhibit 6**), but apart from the very short end of the curve mean reversion has been almost non-existent.
3) In general deviations are very small also suggesting this is not a very fertile ground for RV trading.

Exhibit 7: Shorts in the 5-to 10Y part of the curve remain quite punitive in terms of negative carry

3M carry and slide curve for outright longs in Germany; bp



The carry and slide curve remains dome shaped (**Exhibit 7**): it remains a lot easier to hold shorts at the very long end of the curve especially as we believe it is way too early to position for bearish flattening of the curve.

We have a bias for outright shorts in 30Y and steeper 6s/30s curve and would enter the trades after any pullback. **Exhibit 8** shows a summary of benchmark trades, levels, carry and slide profile and directionality. We generally find that the curve to yield relationships that are still holding relatively well do not give any carry and slide advantage compared to outright shorts and vice versa, positive carry and slide duration proxies have seen diminished directionality.

Exhibit 8: We prefer curve steepeners as carry-efficient short duration proxies

Regression statistics for various German benchmark curves and lies against level of yields; regression horizon 12M; bp

Y variable	2s/5s	2s/10s	7s/15	5s/10s	2s/30s	10s/30s	2s/5s/10s	2s/10s/30s	7s/15s/30s	10Y
X variable	5Y	10Y	10Y	10Y	10Y	10Y	5Y	10Y	10Y	10Y
R-squared (%)	47%	74%	55%	47%	68%	34%	46%	57%	56%	100%
Quad. fit R-squared (%)	47%	80%	61%	65%	75%	41%	48%	59%	60%	
Beta (12M)	0.5	0.9	0.4	0.4	1.2	0.3	0.2	0.3	0.2	1.0
Quad. fit local beta	0.6	0.5	0.2	0.0	0.6	0.1	0.3	0.2	0.1	
Linear fit optical RV (bp)	-2	2	-1	3	4	3	-1	0	-2	
Quad. fit optical RV (bp)	-2	1	-2	2	3	2	-1	-1	2	
3M C+S (bp)	-4	-5	2	-1	-1	4	-2	-5	0	-7
Beta adj. 3M C+S (linear fit, bp	-7	-6	5	-3	-1	12	-7	-15	0	-7
Beta adj. 3M C+S (qaud. fit, bp	-7	-10	11	-206	-2	47	-6	-22	0	-7

Note: 3M carry and slide shown for curve steepeners and belly cheapeners. +ve RV means curve is too flat or fly belly is rich.

[12] See Exhibit 3 of *Euro Cash*, 15 September 2017.

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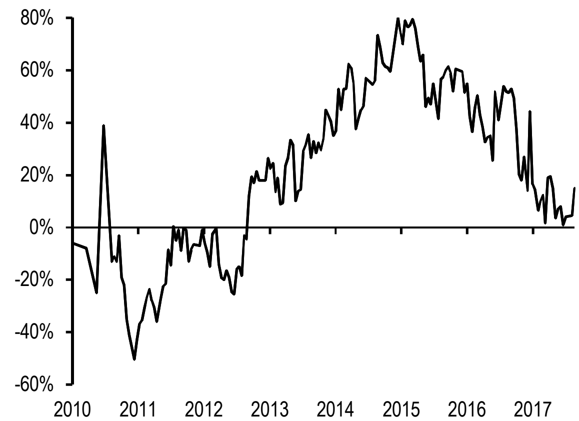
Exhibit 9: Real money investors' peripheral exposure is still very light based on our client survey

Net exposure of Euro area investors to peripherals vs. core; %



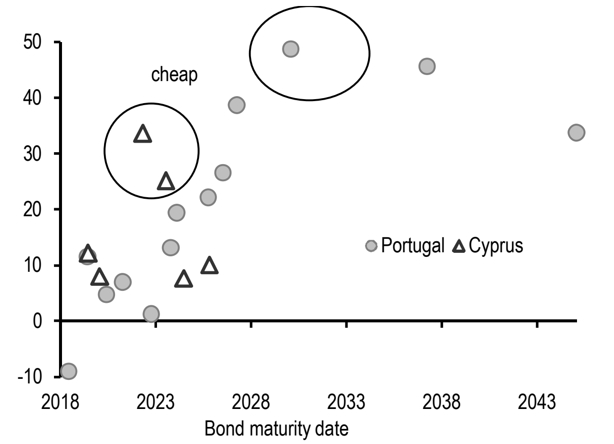
Source: J.P. Morgan European Client Survey

Intra-EMU spreads

This week's price action was dominated by the aggressive market reaction to the surprise Portugal rating upgrade by S&P; other spreads were generally a touch tighter with the exception of 10Y+ Italy. **We keep a medium term modestly negative outlook on intra-EMU spreads** but a variety of factors is making the trade slightly less appealing: *1)* further currency strength might force the ECB to adopt a dovish tone; *2)* Portugal's upgrade is the icing on the cake of improving sentiment towards the region; with real money investor positions still very light (**Exhibit 9**) we see the risk that any sustained widening will happen only later in the year; *3)* more positive newsflow out of Italy (see Special Focus below).

Exhibit 10: We moved Portugal longs vs. Italy from 10Y to 13Y and hold long 5Y Cyprus vs. Germany

Cypriot and Portuguese bonds vs. interpolated Italian yields; bp



We have been recommending UW in Spain (due to short term Catalan noise) and in Italy (medium term concerns about the next general election) offset by an OW in Portugal and Cyprus. We have covered the outlook for Portugal in a separate piece (*Take part profit on Portugal OW*, 21 Sep): after the sharp rally we do not see much value in chasing a further OT outperformance in <10Y maturities (but we like 5Y Portuguese covered bonds, see *Covered Bond Cross-Asset Outlook: September 2017*, 20 Sep). Trading-wise **we switched from 10Y Portugal longs vs. Italy to 13Y** (**Exhibit 10**) and close longs in 10Y Portugal and Germany vs. Spain. We remain **long 5Y Cyprus** but we find other parts of the curve already too tight (Exhibit 10).

Periphery trading ideas

In Italy, we take the opportunity to unwind our 30Y BTP short vs. Germany after this week's underperformance and focus instead on UW proxies. We still find the 5Y sector cheap cross market and **hold 5s/10s Italy steepener vs. Spain**.

Exhibit 11: We favour longs in BTPs Oct23, Dec26, Jun27 and Mar32 vs. surrounding high coupon bonds

Statistics of various flies on Italian curve with low coupon body and high coupon wings; darker colouring means more attractive; bp

Wing1	Body	Wing2	# obs	Latest cob	Z-score	Bp from average	Price diff.	Current benchmark?
01-Sep-22	15-Sep-22	01-Nov-22	269	1.1	1.1	2.2	-20	No
01-Nov-22	15-Mar-23	01-May-23	269	-1.6	0.2	0.6	-20	No
01-Aug-23	15-Oct-23	01-Nov-23	268	2.8	0.9	1.9	-44	No
01-Mar-24	15-May-24	01-Sep-24	141	0.3	-0.5	-0.5	-15	No
01-Mar-25	01-Jun-25	01-Mar-26	269	2.2	1.0	2.6	-24	No
01-Mar-25	01-Dec-25	01-Mar-26	269	2.1	0.9	2.0	-20	No
01-Mar-26	01-Jun-26	01-Nov-26	269	3.8	1.1	3.2	-32	No
01-Nov-26	01-Dec-26	01-Nov-27	269	3.7	0.6	2.1	-50	No
01-Nov-26	01-Jun-27	01-Nov-27	171	7.5	1.6	2.6	-41	No
01-Nov-26	01-Aug-27	01-Nov-27	60	10.1	1.6	1.3	-42	Yes
01-May-31	01-Mar-32	01-Feb-33	269	-5.3	1.2	5.4	-50	No
01-Feb-33	01-Sep-33	01-Aug-34	176	0.6	1.2	4.0	-39	Yes
01-Aug-34	01-Sep-36	01-Feb-37	269	-1.6	1.4	6.0	-27	Yes

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Exhibit 12: The BTP Mar32 is now pricing too little low-coupon premium

BTP 50:50 May31/Mar32/Feb33 fly regressed against BTP Mar32 clean price; past 12M; bp

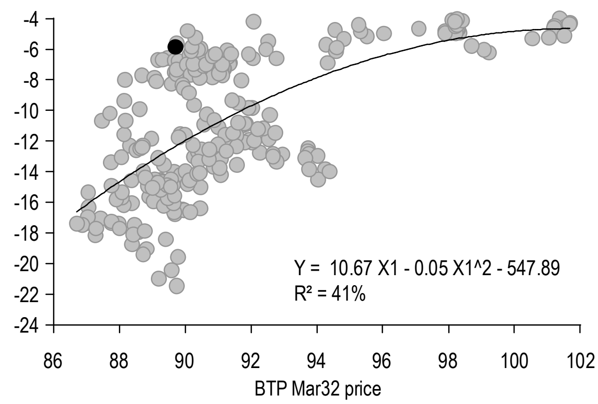
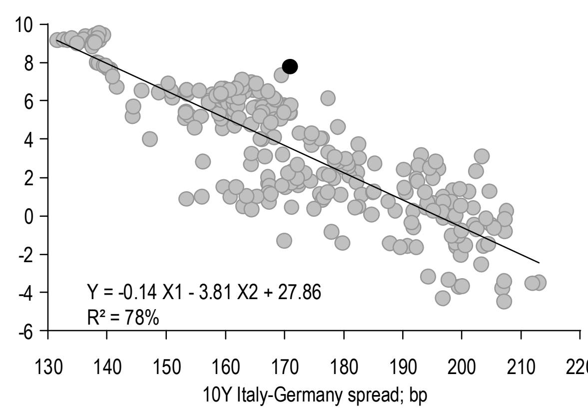


Exhibit 13: The BTP Sep44/Mar47 is trading almost 5bp cheap after adjusting for the credit spread and risk-free rate

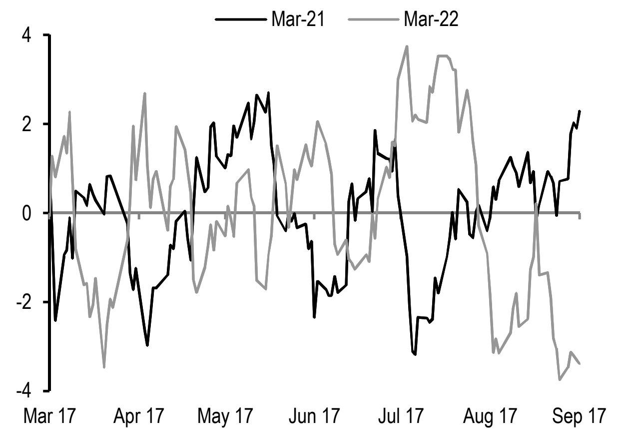
BTP Sep44/Mar47 curve regressed against 10Y Italy-Germany spread (X1) and 30Y German benchmark yield (x2); past 12M; bp



We have been flagging overweighting low-coupon BTPs vs. high-coupon ones as an attractive bearish proxy. During the recent widening move in Italy, the low-coupon BTPs in general underperformed relative to surrounding high-coupon BTPs, thereby creating some attractive opportunities. **Exhibit 11** shows an update on our favourite flies based on a theoretical framework. We favour longs in BTPs Oct23, Dec26, Jun27 and Mar32 vs. surrounding high coupon bonds, and hold longs in BTPs Oct23 and Jun27 vs. surrounding high-coupon BTPs in our portfolio. We also highlight the following: *1)* the BTP Mar32 underperformed vs. the high-coupon BTPs May31 and Feb33 and is now pricing too little low-coupon premium (around 5bp cheap, **Exhibit 12**). *2)* The low-coupon BTP Mar47 underperformed relative to the high-coupon BTP Sep44 and is now trading almost 5bp cheap vs. the Sep44 after adjusting for 10Y Italy-Germany credit spread and the 30Y German yield (**Exhibit 13**). **We recommend BTP Sep44/Mar47 flattener**.

Exhibit 14: 2Y and 4Y BTPs are dear and 3Y BTPs are cheap on the Italian curve

Residual from regressing *1)* BTP 50:50 Sep19/Mar21/Sep21 fly regressed against the BTP Mar21 yield and the BTP Sep19/Sep21 curve* and *2)* BTP 50:50 Apr19/Mar22/Jun25 fly regressed against the BTP Mar22 yield **; past 6M; bp



* BTP Sep19/Mar21/Sep21 = -0.21*Mar21 + 0.64*Sep19/Sep21 – 0.21; R-squared: 86%.

** BTP Apr19/Mar22/Jun25 = -0.27*Mar22 – 0.23; R-squared: 82%.

We also hold OW in CCTeus vs. BTPs asset swapped as a proxy for Italy UW.

The short end of the Italian curve is quite distorted, with the 2Y and 4Y BTPs dear and 3Y BTPs cheap. We hold longs in BTP Jun21 vs. BTPs Feb19 and Aug23. We also highlight: *1)* the BTP Mar21 is trading more than 3bp cheap vs. the BTPs Sep19 and Sep21 in a curve and level neutral fly (**Exhibit 14**) and *2)* the BTP Mar22 is trading almost 4bp dear vs. the BTPs Apr19 and Jun25 in a level neutral fly (Exhibit 11).

In Spain, we hedge the risk of more negative Catalonia-related headlines in the next few days via shorts in the 5-10Y part of the curve vs. Germany. For instance the Bono Apr24 is trading quite dear on the curve after the strong outperformance over the last week. As new trade, **we recommend a short in the Bono Apr24 vs. the Bund Feb24**. The bond is not special in repo and we, therefore, recommend fading this excessive richening via shorts in the Apr24 vs. Jan22 and Apr26 (**Exhibit 15**). Also at the short end, we find the Bono Jul21 dear and the Bono Jan23 cheap. As highlighted last week, we still find the 5s/30s Bono curve excessively steep, even if less so than before.

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Exhibit 15: The Bono Apr24 is trading more than 4bp dear vs. the Bonos Jan22 and Apr26

Bono 50:50 Jan22/Apr24/Apr26 fly regressed against Bono Apr24 yield (X1) and Bono Jan22/Apr26 curve (X2); past 6M; bp

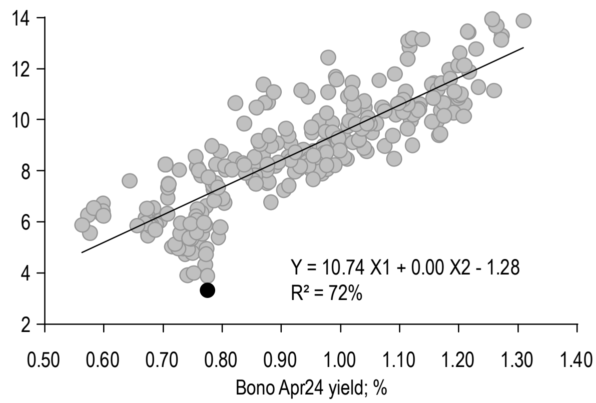
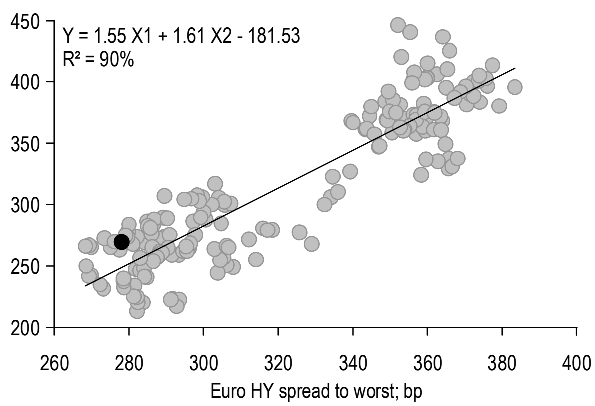


Exhibit 16: We find 10Y Greece-Germany spread marginally too wide based on the fair value framework

10Y Greece-Germany curve adjusted spread regressed against Euro HY spread to worst (X1) and 10Y weighted peripheral spread ex Greece to Germany (X2); bp



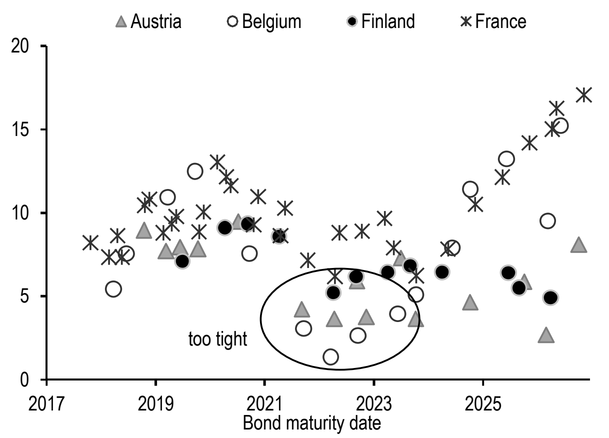
In Portugal, as discussed in a separate piece most valuations seem stretched. **We still like longs in the OT Feb30 vs. Italy**, but we recommend as alternatives at the short end of the curve: 1Y Ireland (give up only 7bp), 5Y CXGD covered bond and 5Y Cyprus.

We close a 8s/23s steepener in Ireland boxed against a flattener in Slovenia: due to a compliance restriction on one of the bonds in the trade.

In Greece spreads widened 5-10bp across the curve over the past few days likely on the back of large sell-off of Greek banks equities over the last week. The bank stocks underperformance was due to two developments: *1)* IMF calling for an asset quality review (AQR) as part of the third review; the European creditors are not in favour of this and *2)* news of an investigation by Bank of Greece in one of the large Greek banks. At current levels, we find the Greek spreads marginally too wide based on the fair value framework based on Euro HY spreads and weighted average 10Y peripheral spreads (**Exhibit 16**). However, we do not recommend fading this widening move as we believe that the Greek spreads will remain under pressure from potential newsflow of conflicts between creditors and government as we enter the third bailout review in coming weeks. Also this week, as per media articles the Greek government is considering plans of swapping the GGB PSI strip bonds for four-five new government bonds in order to improve the liquidity of the GGB market. We do not expect any progress on this until the third review is over (the earliest late 4Q17).

Exhibit 17: 5Y Netherlands is cheap vs. other core, especially vs. Austria and Belgium

Core country bonds vs. interpolated Dutch z-spread curve; up to 10Y; bp



In core space, spreads moved in a tight +/-1bp range expect for 2bp tightening at the long of Austria and Belgium. **We continue to position for selective defensive trades which are supported by supply pressures and valuations**. **We continue to hold shorts in 5Y Belgium vs. Finland and 7Y France vs. Finland and longs in 30Y Austria vs. the Netherlands.**

On valuations we also highlights, the cheapness of the 5Y sector in the Netherlands vs. other core, especially vs. Austria and Belgium (**Exhibit 17**).

In France, the 5Y sector outperformed correcting the flatness of the 5s/10s France-Germany box we highlighted last week. On RV, we highlight: 1) the old 5Y OAT May21 is still quite cheap on the interpolated OAT curve and we hold longs in vs. the OATs Apr21 and Oct21 and 2) we still find the 2025 OATs expensive on the curve (**Exhibit 18**).

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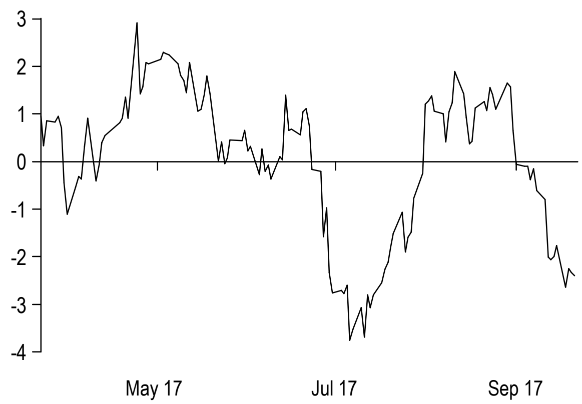
Exhibit 18: The OAT Oct25 is trading 3bp dear vs. the OATs Nov20 and Apr29

Residual from regressing OAT 50:50 Nov20/Oct25/Apr29 fly against OAT Oct25 and OAT Nov20/Apr29 curve*; past 6M; bp



* OAT Nov20/Oct25/Apr29 = 0.24*Oct25 + 0.25*Nov20/Apr29 – 0.27; R-squared: 89%.

In our latest *Covered Bond Cross-Asset Outlook*, we highlighted the following themes: *1)* long-dated covered bonds from core countries are trading cheap vs. SSA; *2)* BBVA covered bonds are dear vs. core covereds; *3)* 5Y CXGD are cheap vs. Portugal; *4)* Select short-dated German pfandbriefe trade cheaper than French OF/OH; *5)* The French covered bond curve is too steep vs. OAT and *6)* UBIIM 1/23 is even cheaper on the UBIIM curve.

Issuance

Euro area conventional supply will be light next week, around €10bn from Germany and Italy (Exhibit 19).

Schatz Sep19: cheap
The Sep19 is trading at a benchmark discount of around 2bp relative to surrounding Bunds, in the upper half of the past year trading range.

Italy auctions
On Thursday, we expect Italy to auction around €6-7bn of BTPs: the 5Y benchmark (BTP Aug22) and the 10Y benchmark (BTP Aug27). As discussed above the 5Y sector is cheap cross market vs. Spain and we hold 5s/10s steepener vs. Spain. With in the sector, the BTP Aug22 has cheapened since issuance in late July and is now trading at a benchmark discount of 5bp, at the upper end of the past year range. The 10Y benchmark is trading with a benchmark roll (z-spread pick-up over off –the-run BTP Jun27) of around 4bp, broadly in the middle of past year benchmark roll range.

Exhibit 19: Euro area conventional supply will be light next week

Euro area conventional bond issuance calendar for the next two weeks; official announcements and J.P. Morgan forecast; peripheral supply highlighted in grey; €bn

		Issuer	Short	Medium	Long	Ultralong
Tue	26-Sep	Germany	Sep19 4.0			
Thu	28-Sep	Italy		3.0	3.5	
Wed	04-Oct	Germany			Aug27 3.0	
Thu	05-Oct	France			5.0	3.0
Thu	05-Oct	Spain		1.5	1.5	1.0

In the Netherlands, the 2017 borrowing requirements were lowered by around €8bn due to significant increase in the cash surplus and privatization receipts. However, the DSTA envisages lower money market funding on back of lower funding needs. The DSTA's 2017 DSL gross issuance target is €31.6bn. However, we stick with our €33bn target as we expect more 2018 DSL buybacks between now and the year end. In 4Q, the DSTA will launch a new 7Y (DSL Jan24) on 10 October and will tap conduct one DSL Jul27 tap on 14 November.

Special focus I: Italian politics update

In our view the newsflow is at the margin positive for Italian assets, but we still expect enough uncertainty to warrant spread widening into the end of the year.

Somewhat surprisingly four Italian parties (PD, Forza Italia, Northern League and AP) agreed on a new electoral law, a market positive event in our view. **Exhibit 20** shows the main features of the law compared to the aborted May proposal and the existing patchwork. If implemented, and assuming no significant changes in the polls and pre-vote coalitions between centre-right and centre-left parties, the law would penalise Five Stars, but still result in a hung Parliament.[13] The coalitions would then have to be dismantled to allow for the formation of a grand coalition government. We remain of the view that a coalition encompassing PD, AP and Forza Italia would be the most market-friendly plausible outcome.

Under the most optimistic expectations *i)* the Lower House subcommission will start to vote on the law next week, *ii)* voting in the Lower House would start the following week with approval by mid-October; *iii)* a vote in the Upper House would take place after the approval of the 2018 Budget, and *iv)* the process would end by November/December. However, media reports have

[13] If the not-so-secret attempt is to penalise Five Stars, this could be a risky strategy. Increasing support for Five Stars would swing the non-linearity of the first-past-the post system in favour of Five Star candidates.

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Exhibit 20: If approved, on paper, the new electoral law would increase chances of a benign outcome after the general election

Main features of recent proposals and current electoral law

	September proposal (both Lower & Upper House)	May proposal (Lower & Upper House)	Lower house	Upper house
Baseline	36% first-past-the-post, 64% proportional	Proportional system	Proportional system	Proportional system
Bonus	No bonus	No bonus	54% of seats go to the party list/symbol (not the coalition) that gets >40% of the votes at national level	-
Thresholds for MP allocation	Party list needs >3%, coalition needs >10% at national level (the contribution of parties that get <1% does not count)	5%	Party list needs >3% at national level	Party list needs >8%, >3% if part of a coalition; coalition needs >20% (at regional level)
Expected implications compared to current law	Favours coalitions, penalises Five Stars based on current polls, but still likely to produce hung Parliament; higher probability of post-election Grand Coalition	Favours the largest parties		

Source: media reports; J.P. Morgan

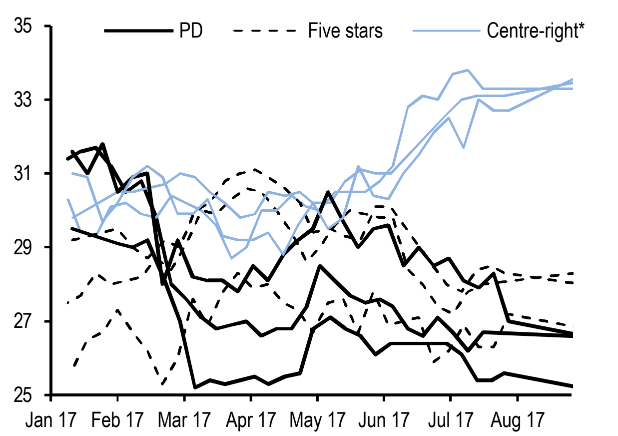
already highlighted that the law might be torpedoed in secret ballot votes, similar to what happened to the May proposals. Media reports over the coming days will help fine-tuning the probability.

Polls have shown very little variation recently (**Exhibit 21**): the three most frequent pollsters have centre-right at 32-33%, PD (without the contribution of any potential allied parties) at 25-27% and Five Stars at 27-28%. The crowning of Di Maio and leader of Five Stars and PM candidate is not running smoothly but Five Stars support has so far proven very resilient to various hiccups. The usual caveats about poll unreliability and strategic behaviour once the electoral system is finalised apply.

A poll for the regional vote in Sicily scheduled for 5 November was finally published. It shows the centre-right candidate at 33.1%, with the Five Stars candidate second at 31.6% and the centre-left one at 27.3%. If the message were confirmed by the actual vote, the victory of the centre-right candidate instead of the Five Star one should be taken as market positive. However, if the victory is too convincing the mood might sour as it would increase the chance of a centre-right government

Exhibit 21: PD alone is lagging centre-right and Five Stars but the new electoral law encourages alliances

Evolution of support for PD, Five Stars and centre-right* as measured by the four most frequent pollsters (average of EMG, Index, Ixè and SWG); %



* Forza Italia + Northern League + Fratelli d'Italia

Source: EMG, Index and SWG (Ixe has not published any polls since early August); J.P. Morgan

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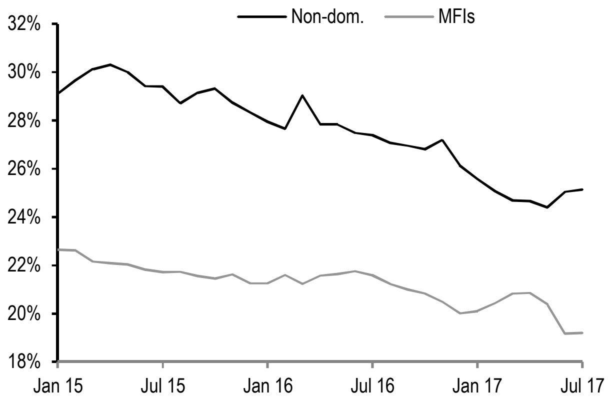
Exhibit 22: In June and July we saw large selling of Italian government debt securities by domestic banks and buying by non-domestics

Evolution of non-domestic and domestic MFIs holdings of Italian general government securities*; % of total; latest data as of July 2017

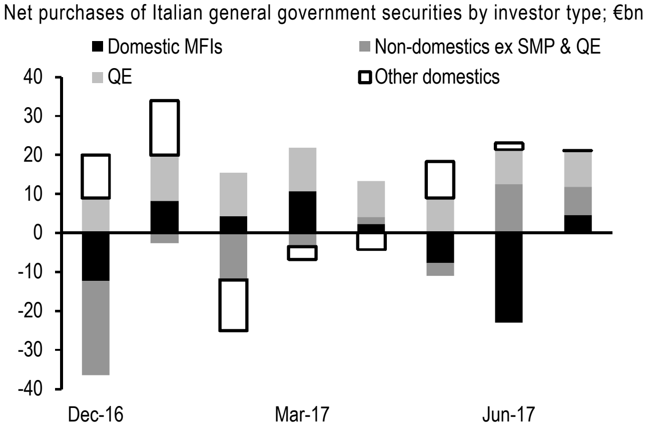


*Non-domestic holdings exclude ECB SMP & QE holdings. It also excludes Italian securities held abroad but attributable to Italian savers.

Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

Exhibit 23: Private non-domestic investors became net-buyers of Italy in June and July, after being overall net sellers since December 2016

Net purchases of Italian general government securities by investor type; €bn



Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

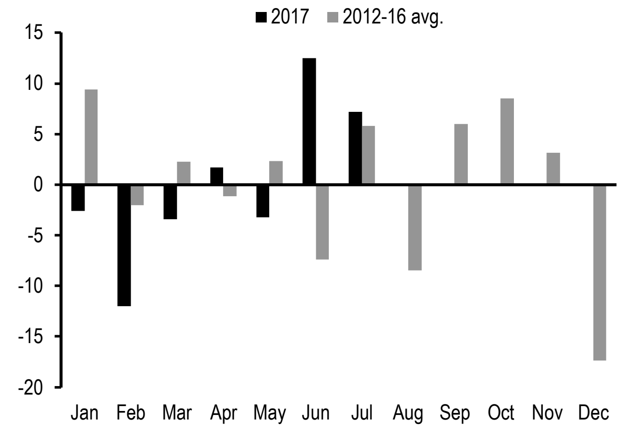
at national level rather than the more market-friendly grand coalition.

Special focus II: Summer brings non-domestics back to Italy

Over the past few months, there have been two interesting trends in the investor composition of Italian government bonds: large selling by Italian banks[14] and

Exhibit 24: The non-domestic inflows in July were likely the result of investors putting carry trades before the summer supply lull, in line with the historical seasonality

Net transactions in Italian government securities by non-domestic (ex ECB QE) investors; €bn



Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

buying from private non-domestics (ex ECB QE) investors (**Exhibit 22**). In this note, we analyse the non-domestic holdings of Italian government debt securities. **We believe the inflows in June were to cover the selling from domestic banks and the inflows in July were likely the result of investors putting carry trades before the summer supply lull, in line with the historical seasonality**.

<u>What has been the recent trend in private non-domestic holdings?</u>

Private non-domestic investors became net-buyers of Italy in June and July, after being overall net sellers since December 2016 (**Exhibit 23**). Based on our estimates, the private non-domestic investors added almost €20bn to their holdings of Italian govies in June and July together, broadly offsetting the €20bn selling in the first five months of 2017.

<u>What could explain the recent inflows?</u>

The inflows in June are not explained by the historical seasonality, as over the past few years non-domestics have been on average net-sellers of Italy in June (**Exhibit 24**). In June, the domestic banks were large net-sellers of Italian govies and the non-domestic investors, including the ECB QE, absorbed these selling flows.

We believe that the inflows in July are likely the result of investors putting carry trades before the summer supply lull, a trend observed over the past few years.

[14] In a previous special focus (Euro Cash 11 August), we analysed the selling by the Italian banks of their government's bonds and concluded that low level of BTP yields around May and June, and ongoing desire to diversify their portfolios were the likely reason behind their large selling.

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Exhibit 25: The behaviour of private non-domestic investors is close to the average of the other holders of Italian debt over the QE horizon
Estimation of evolution of ownership of Italian government debt since beginning of QE programme; €bn

	Jul-17	Feb-15	Chg.	% chg.	Current split
Central bank ex SMP & QE	89	89	0	0%	5%
Other MFIs	374	414	-39	-10%	19%
Other financial institutions	435	426	9	2%	22%
Other residents	124	179	-54	-30%	6%
Inv. funds attributable to doms.	129	105	24	23%	7%
Non-domestic ex SMP & QE	490	542	-52	-10%	25%
SMP & QE	307	74	233	317%	16%
Total	1948	1828	121	7%	100%
Toal ex SMP and QE	1642	1754	-113	-6%	84%

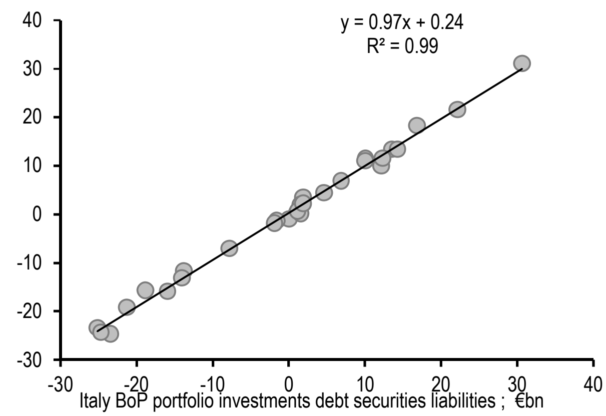
Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

What has been the trend over the QE period?
The behaviour of private non-domestic investors is close to the average of the other holders of Italian debt. Since the beginning of QE purchases in March 2015, the stock of debt ex SMP and QE is down by 6%, whereas the private non-domestic portfolio is down by a similar amount, 10% (**Exhibit 25**). The domestic bank portfolio is also down by 10% over the same period. Insurance companies and mutual fund holdings actually increased over the period, whereas the Bank of Italy kept the non-SMP&QE portfolio stable.

How do we track the non-domestic (ex ECB QE) holdings of Italian government securities?
The Bank of Italy publishes the investor split data with data for total non-domestic holdings on a monthly basis. We clean the overall non-domestic holdings data for ECB QE and SMP holdings and for holdings of Italian investment funds bases outside of Italy. The central bank publishes the data with a three-month lag, hence the most recent data is as of June 2017. To get a timelier estimate, we use the Balance of Payment data which is published with a two month lag. Historically BoP portfolio investment liabilities in general government debt securities have been strongly correlated with the non-domestic flows (**Exhibit 26**).

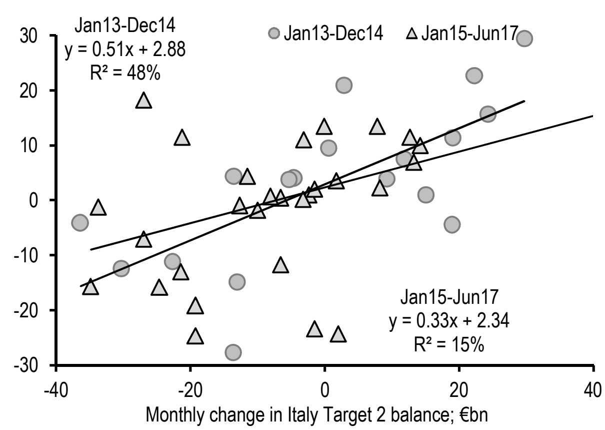
Using Target2 data to estimate non-domestic flows in Italian government bonds would reduce the lag to one month. Unfortunately recently the relationship between Target2 and non-domestic flows in general government bonds has broken down (**Exhibit 27**), as other factors such as large domestics buying of foreign debt and equities have been the key drivers of Target2 in Italy.[15]

Exhibit 26: Historically BoP portfolio investment liabilities in general government debt securities have been strongly correlated with the non-domestic flows in Italy
Monthly non-domestic transactions into Italian debt securities regressed against Italian BoP portfolio investment liabilities in general government debt securities; €bn



Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

Exhibit 27: Recently the relationship between Target2 and non-domestic flows in general government bonds has broken down
Monthly non-domestic transactions into Italian debt securities regressed against monthly change in Italian Target 2 balance; €bn



Source: Italian central bank, Italian DMO, ECB, J.P. Morgan

We therefore do not rely on Target2 data in our estimates.

Trade recommendations[16]

High-conviction trades are starred (★). All other recommendations are moderate-conviction.

New trades:
- **Open short 7Y Spain vs. Germany**

[15] See *Special Focus: How worried should we be about Italy's Target2 continued deterioration?* in *Euro Cash*,. 3 March 2017.

[16] Unless specified all trades are priced as of 1PM on non-payroll Fridays and 2PM on payroll Fridays.

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– Open short €25mn Bono Apr24 vs. long €26.0mn Bund Feb24 @ 86.0bp. 3M carry: -1.9bp and 3M slide: -3.1bp.

Closed trades:

- **Close short 30Y Germany**
  – Close short €100mn Bund Aug46 @ 123.4bp. P&L since inception (1 September 2017): 6.3bp.
- **Close short 30Y Italy vs. Germany**
  – Close short €50mn BTP Mar48 vs. long €33.9mn Bund Aug46 @ 215.0bp. 3M carry: -2.6bp and 3M slide: 0bp. P&L since inception (18 August 2017): 3.5bp.
- **Close 8s/23s Slovenia flattener vs. Ireland**
  – Close long €5mn Slorep Nov40 vs. short €10.3mn Slorep Jul25 and short €3.9mn Irish Feb45 vs. long €9.4mn Irish Mar25 @ 15.2bp. P&L since inception (4 August 2017): 9bp.

German duration, curve & RV trades:

- **Keep long Bund Feb23 vs. 47% Bund Jan22 and 53% Bund Feb24**
  – Keep long €100mn Bund Feb23 vs. short €57mn Jan22 and €39mn Feb24 @ 1.9bp. 3M carry and slide: -1bp. P&L since inception (28 April 2017): 0.0bp.

Country selection & RV trades:

- **Keep long 5Y Cyprus vs. Germany**
  – Keep long €5mn Cyprus May22 vs. short €4.6mn Bund Jul22 @ 134bp. 3M carry: 8bp and 3M slide: 6bp. P&L since inception (9 September 2017): 49bp.
- **Keep long 13Y Portugal vs. Italy**
  – Keep long €25mn OT Feb30 vs. short €23.9mn BTP Mar30 @ 49.2bp. 3M carry: 1bp and 3M slide: 0.5bp. P&L since inception (21 September 2017): -0.2bp.
- **Keep long 30Y Austria vs. Netherlands**
  – Keep long €25mn RAGB Feb47 vs. short €19.6mn DSL Jan47 @ 28.8bp. 3M carry: 0.5bp and 3M slide: 0bp. P&L since inception (15 September 2017): 2.2bp. Readers can view this trade in our *Trade Analyser* by clicking here.
- **Keep short 5Y Belgium vs. Finland (★)**
  – Keep short €25mn OLO Sep22 vs. long €27.2mn RFGB Sep22 @ -4.1bp. 3M carry and slide: -0.5bp. P&L since inception (24 February 2017): -7.1bp. Readers can view this trade in our *Trade Analyser* by clicking here.
- **Keep long 1Y Ireland vs. Finland**
  – Keep long €50mn Irish Oct18 vs. short €55.7mn RFGB Sep18 @ 16.6bp. 3M carry: -1bp and 3M slide: 1.5bp. P&L since inception (16 June 2017): 1.8bp.
- **Keep long 7Y Finland vs. France**
  – Keep long €50mn RFGB Sep23 vs. short €42.6mn OAT Oct23 @ 1.7bp. 3M carry: -0.5bp and 3M slide: 0bp. P&L since inception (21 July 2017): -3.7bp. Readers can view this trade in our *Trade Analyser* by clicking here.
- **Keep long 8Y Ireland vs. France**
  – Keep long €25mn Irish Mar25 vs. €29.2mn OAT May25 @ 16.6bp. 3M carry: -0.5bp and 3M slide: 0.5bp. P&L since inception (4 August 2017): -1.8bp Readers can view this trade in our *Trade Analyser* by clicking here.
- **Keep 5s/10s Italy steepener vs. Spain**
  – Keep short €50mn BTP Aug27 vs. long €95.3mn BTP Apr22 and long €48.9mn Bono Apr27 vs. short €92.8mn Bono Apr22 @ 21.9bp. 3M carry: 1.5bp and 3M slide: 2.5bp. P&L since inception (21 July 2017): 4.9bp.
- **Keep long OAT May21 vs. OATs Apr21 and Oct21 (-84%/100%/-16%)**
  – Keep long €50mn OAT May21 vs. short €39.3mn OAT Apr21 and €6.7mn OAT Oct21 @ 2.6bp. 3M carry: 0bp and 3M slide: 0bp. P&L since inception (4 August 2017): 0.3bp.
- **Keep short BTP Jun21 vs. BTPs Feb19 and Aug23 (19%/-100%/65%)**
  – Keep short €25mn BTP Jun21 vs. long €12.4mn BTP Feb19 and €9.5mn BTP Aug23 @ -33.4bp. 3M carry: -1bp and 3M slide: -3bp. P&L since inception (21 September 2017): -1.5.
- **Keep long BTP Oct23 in -18%/100%/-82% BTP Aug23/Oct23/Nov23 fly**
  – Keep long €25mn BTP Oct23 vs. short €4.1mn BTP Aug23 and €15.9mn BTP Nov23 @ 3.2bp. 3M carry: -0.5bp and 3M slide: 0.5bp. P&L since inception (11 August 2017): -1.8bp.
- **Keep long BTP Jun27 in -42%/100%/-58% BTP Nov26/Jun27/Nov27 fly**
  – Keep long €25mn BTP Jun27 vs. short €8.7mn BTP Nov26 and €11.3mn BTP Nov27 @ 7.7bp. 3M carry and slide: -1bp. P&L since inception (3 March 2017): -5.3bp.
- **Keep long protection in 5Y USD France CDS 2003 contract (★)**

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– Keep long protection in €25mn 5Y USD France CDS 2003 contract @ 17.0bp. P&L since inception (7 April 2017): -12.0bp.

- **Keep long 8Y CCTeu vs. BTP**

– Keep long €25mn CCTeu Oct24 vs. long BTP Dec24 ASW (long BTP Dec24 and paying in 6s EUR swap maturing 1 Dec 2024) @ -4.2bp. P&L since inception (12 May 2017): -3.8bp.

SSA trades:

- **Keep short 10Y EIB vs. swap**

– Keep short €25mn EIB Jan27 vs. receiving €24.4mn Jan27 Euro swap @ -25.4bp, 3M carry: 0bp and 3M slide: -0.5bp. P&L since inception (31 August 2017): 0.1bp.

- **Keep 10s/30s EFSF steepener vs. Germany**

– Keep short €25mn EFSF May47 vs. long €62.9mn EFSF May26 and long €19.0mn Bund Aug46 vs. short €62.2mn Bund Feb26 @ -3.2bp. P&L since inception (10 May 2017): -18.5bp.

- **Keep long 3Y EFSF vs. France**

– Keep long €25mn EFSF Oct20 vs. short €24.6mn OAT Oct20 @ 13.2bp. 3M carry: 0.5bp and 3M slide: 1bp. P&L since inception (15 June 2017): 1.9bp.

- **Keep long 4Y KfW vs. Belgium**

– Keep long €25mn KfW Apr22 vs. short €22.6mn OLO Mar22 @ 12.0bp. 3M carry: 1bp and 3M slide: 0bp. P&L since inception (15 June 2017): -1.4bp.

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Trades closed over the past 12 months

TRADE	ENTRY	EXIT	P&L
DURATION			
Short 15Y Germany	16-Sep-16	14-Oct-16	4.3
Short 10Y Germany	23-Nov-16	09-Dec-16	9.1
Long 2Y Germany	06-Jan-17	01-Mar-17	16.7
Short 30Y Germany	07-Apr-17	07-Jun-17	10.0
Long 2Y Germany	16-Jun-17	14-Jul-17	2.6
Long 2Y Germany	14-Jul-17	04-Aug-17	5.0
Short 30Y Germany	11-Aug-17	18-Aug-17	3.6
Short 30Y Germany	01-Sep-17	22-Sep-17	6.3
CURVE			
Bund Jan19/Jan21 steepener	05-Aug-16	14-Oct-16	4.1
2s/5s German flattener	21-Oct-16	28-Oct-16	-7
10s/30s wtd. steepener	11-Nov-16	02-Dec-16	0
2s/3s flattener	23-Nov-16	09-Dec-16	1.6
10s/30s steepener	23-Nov-16	10-Feb-17	20.5
Long body in wtd. Bund Jan19/Jan20/Jan21 fly	11-Feb-17	03-Mar-17	1.6
2s/5s German steepener	07-Apr-17	28-Apr-17	3.5
7S/15s steepener	10-Mar-17	23-Jun-17	-10.2
10s/30s steepener	23-Jun-17	21-Jul-17	3.5
6s/30s steepener	21-Jul-17	01-Sep-17	4.0
COUNTRY SELECTION/RELATIVE VALUE			
Long 6Y Cyprus vs. Portugal	08-Jul-16	30-Sep-16	41.0
Long 15Y Ireland vs. France	30-Sep-16	14-Oct-16	3.5
Short 20Y Austria vs. Germany	30-Sep-16	14-Oct-16	3.0
Long 5Y Slovenia vs. Spain	16-Sep-16	14-Oct-16	14.0
Long body in wtd. OAT Oct22/Oct32/May45 fly	05-Aug-16	14-Oct-16	2.3
Long 20Y Netherlands vs. Germany	30-Sep-16	21-Oct-16	2.0
Long 3Y Austria vs. Germany	22-Jul-16	21-Oct-16	4.5
Long 15Y Italy vs. Germany	21-Oct-16	28-Oct-16	-8.0
2s/10s Portugal flattener vs. Germany	14-Oct-16	28-Oct-16	9.0
15s/30s Belgium steepener vs. Germany	14-Oct-16	28-Oct-16	2.0
Short 7Y Austria vs. Germany	22-Jul-16	28-Oct-16	2.0
Long 5Y Netherlands vs. Belgium	30-Sep-16	04-Nov-16	1.0
Short 7Y France vs. Finland	21-Oct-16	11-Nov-16	3.0
Long body in wtd. BTP Aug34/Sep36/Feb37 fly	05-Aug-16	11-Nov-16	8.5
Short 10Y Italy vs. Portugal and 10Y Germany	11-Nov-16	02-Dec-16	-14.0
Long 10Y Belgium vs. France	11-Nov-16	02-Dec-16	3.0
Short 5Y CCTeu vs. BTP	11-Nov-16	02-Dec-16	18.0
Long 5Y Slovenia vs. Spain	28-Oct-16	02-Dec-16	11.0
DSL Jan42/Jan47 steepener	07-Sep-16	09-Dec-16	0.0
RAGB Oct26/Jul27 steepener	14-Oct-16	09-Dec-16	1.5
Long body in wtd. OAT Feb19/Apr26/May31 fly	04-Nov-16	09-Dec-16	-7.3
Long body in wtd. OAT May30/May45/Apr60 fly	09-Sep-16	09-Dec-16	-4.8
Long body in wtd. OAT Feb19/Apr22/Oct23 fly	28-Oct-16	09-Dec-16	0.5
Short 6Y Netherlands vs. Germany	02-Dec-16	20-Jan-17	5.5
Long 2Y Spain vs. Germany	22-Jul-16	20-Jan-16	20.5
Long 4Y Finland vs. Netherlands	09-Dec-16	20-Jan-17	2.5
Long body in wtd. BTP Aug34/Sep36/Feb37 fly	13-Jan-17	20-Jan-17	2.5
Long 2Y Ireland vs. Germany	19-Aug-16	27-Jan-17	1.5
Long 5Y Cyprus	21-Oct-16	27-Jan-17	24.0
6s/8s France steepener vs. Netherlands	21-Oct-16	27-Jan-17	2.5
Short 7Y France vs. Belgium	02-Dec-16	02-Feb-17	10.5
Long 30Y Ireland vs. France	06-Jan-17	02-Feb-17	7.3
Short 15Y Spain vs. Germany	27-Jan-17	10-Feb-17	21.0
Short 30Y Finland vs. Germany	06-Jan-17	10-Feb-17	5.0
10s/30s Belgium steepener vs. Germany	03-Feb-17	10-Feb-17	2.0
BTP Nov27/Sep28 flattener	20-Jan-17	10-Feb-17	3.0
Short 3Y Italy vs. Spain	02-Dec-17	24-Feb-17	15.0
OLO Jun31/Mar32 flattener	20-Jan-17	24-Feb-17	1.0
BTP Mar25/Jun25 flattener	11-Nov-16	24-Feb-17	6.0
3s/10s Italy flattener vs. Germany	27-Jan-17	24-Feb-17	13.0
Lond body in BTP May31/Mar32/Feb33 fly	27-Jan-17	24-Feb-17	4.5

TRADE	ENTRY	EXIT	P&L
COUNTRY SELECTION/RELATIVE VALUE (contd)			
Short 10Y France vs. Germany	16-Sep-16	01-Mar-17	45.5
Short 25Y Netherlands vs. Germany	04-Nov-16	03-Mar-17	2.0
2s/10s Italy flattener vs. Germany	03-Mar-17	10-Mar-17	4.0
OAT May36/Oct38 steepener	02-Feb-17	24-Mar-17	5.5
10s/30s Italy steepener vs. Spain	10-Mar-17	31-Mar-17	4.0
10s/30s France steepener vs. Germany	03-Mar-17	31-Mar-17	2.0
3s/5s Spain steepner vs. Italy	15-Jul-16	31-Mar-17	-15.0
Short 10Y France vs. US	24-Mar-17	19-Apr-17	11.0
Short 3Y Netherlands vs. Finland	03-Mar-17	21-Apr-17	-2.0
Long France/Italy/Spain vs. Germany (57%/17%/27%	24-Mar-17	28-Apr-17	6.5
Long 20Y Greece	23-Nov-16	28-Apr-17	68.0
Short 4Y Ireland vs. France	28-Oct-16	28-Apr-17	2.0
3s/10s France flattener vs. Germany	24-Mar-17	04-May-17	3.5
Shorrt CCTeu Feb24 vs. BTP Mar24	03-Feb-17	05-May-17	11.0
Long 8Y Irealnd vs. France	05-May-17	11-May-17	2.0
Long body in wtd. OT Jun20/Feb24/Jul26 fly	11-Feb-17	11-May-17	-12.0
3s/10s Portugal flattener vs. Germany	06-Jan-17	19-May-17	18.0
10s/30s AT, FR, IT & ES steepener vs. DE	05-May-17	02-Jun-17	-4.5
Short 10Y Italy vs. Portugal & Spain wtd.	11-May-17	09-Jun-17	5.5
Short 10Y France vs. Germany	04-May-17	09-Jun-17	-8.5
Short 15Y Belgium vs. France and Irealnd	02-Jun-17	09-Jun-17	3.0
Long 10Y Portugal vs. Germany	09-Jun-17	16-Jun-17	15.0
DSL Jul21/Jan22 flattener vs. Bund Jul21/Jan22	03-Feb-17	16-Jun-17	2.8
Long 10Y Portugal & Spain vs. Germany	16-Jan-17	23-Jun-17	-1.0
Long 3Y France vs. Netherlands	09-Jun-17	23-Jun-17	3.5
2s/5s Netherlands flattener vs. Germany	16-Jun-17	23-Jun-17	2.5
3s/10s Italy steepener vs. Germany	11-May-17	23-Jun-17	1.0
Bono 6% Jan29/1.95% Jul30 flattener	03-Mar-17	23-Jun-17	0.5
Short 10Y Italy vs. wtd. Spain & Portugal	23-Jun-17	07-Jul-17	10.5
Long 9Y Slovenia vs. Austria	19-May-17	07-Jul-17	20.0
4s/10s Portugal flattener vs. Italy	16-Jun-17	14-Jul-17	1.0
Short body in wtd. Irish May26/May30/May37 fly	07-Jul-17	14-Jul-17	3.0
Short 8Y France vs. Belgium	28-Apr-17	21-Jul-17	-8.0
Long 20Y Ireland vs. France	09-Jun-17	04-Aug-17	1
3s/10s France steepener vs. Germany	14-Jul-17	04-Aug-17	0.5
3s/10s Spain flattener vs. Germany	24-Mar-17	04-Aug-17	6.5
10s/20s Portugal steepener vs. Germany wtd.	05-May-17	04-Aug-17	-7
Long belly BTP Feb33/Sep33/Aug34 fly	21-Apr-17	11-Aug-17	-4
Long 5Y Cyprus vs. Germany	24-Mar-17	18-Aug-17	115
Long 6Y Portugal vs. Spain	04-Aug-17	18-Aug-17	5.5
Long 23Y Slovenia vs. France	21-Jul-17	18-Aug-17	11
Short body in wtd. OAT May19/Apr20/May21 fly	04-Aug-17	18-Aug-17	1.5
Long belly in wtd. BTP Oct19/Dec21/Oct23 fly	04-Aug-17	01-Sep-17	1.5
Short 11Y Finland vs. France	11-Aug-17	08-Sep-17	-5.5
Short 27Y Austria vs. Germany	07-Apr-17	15-Sep-17	0.5
Long 10Y Portugal vs. Italy	14-Jul-17	21-Sep-17	50.5
Short 10Y Spain vs. Portugal & Germany	09-Sep-17	21-Sep-17	23.5
Short 30Y Italy vs. Germany	18-Aug-17	22-Sep-17	3.5
8s/23s Slovenia flattener vs.Ireland	04-Aug-17	22-Sep-17	9
SSA			
Long 3Y KfW vs. France	12-Oct-16	18-Jan-17	8
Long 2Y EU vs. France	18-Jan-17	27-Jan-17	5
10s/30s EFSF steepener vs.Germany	16-Nov-16	30-Mar-17	10.7
5s/10s NRW steepener vs. Germany	22-Feb-17	10-May-17	4
10s/30s ESM flattener vs. Germany	30-Mar-17	10-May-17	5
5s/10s NRW steepener vs. France	10-May-17	15-Jun-17	6
3s/10s EFSF steepener vs. France	10-May-17	15-Jun-17	16
Long 4Y EU vs. Belgium	30-Mar-17	26-Jul-17	8.5
Long 10Y EFSF vs. Germany	26-Jul-17	31-Aug-17	-3
MISCELLANEOUS			
Short 10Y Germany vs. US	06-Jan-17	24-Mar-17	4.0

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European Derivatives

- **Valuations are less stretched with 15bp of hike in the depo rate almost fully priced in by Mar19**
- **We believe that without a change in sequencing market should price less tightening by 3Q18 but tactically close Sep18/Mar19 ECB OIS curve steepener**
- **Keep paying Dec19 ECB OIS outright as market still under prices our pace of normalization. However, close short the body of Dec18/Dec19/Dec20 50:50 Euribor butterfly**
- **We have a bias to pay 10Y in the 5s/10s/30s 50:50 EUR swap fly as positive convex bearish trade**
- **Intermediates are expected to underperform if the sell off continues: initiate 2s/5s weighted bear steepener and hold 2s/5/s10s bear belly cheapener**
- **Bullish hedges: hold 3s/30s and reds/blues weighted bull flatteners**
- **15Yx5Y is no longer cheap on the curve vs. surrounding 5Y forwards**
- **Special focus: Money market and benchmark reform, a new index from the ECB**
- **Schatz swap spread appears fair vs. fundamental drivers but we keep a medium term widening bias on expected increase in funding pressure, given recent widening between RFR Germany and German GC; target 35-36bp in Schatz OIS swap spread to initiate widener**
- **Bund swap spread is trading too wide vs. fundamental drivers. However narrowers may now be a crowded trade and we tactically take profit on Bund OIS swap spread narrower, but hold Schatz/Bund swap spread curve flattener**
- **Keep OTM Dec17 Bund swap spread conditional bull widener**
- **Stay short 112.1/111.9 Dec17 Schatz unhedged strangles**
- **Hold Schatz/Bund vol curve steepener but take small profit in long 10Yx10Y vega**
- **Take profit in long in 2Y UST OTM puts vs Schatz puts**

Exhibit 1: Over the past week the EONIA curve bear steepened with blues and golds underperforming on the curve
Change in 1Y spot and forward EONIA since 15 September 2017; bp

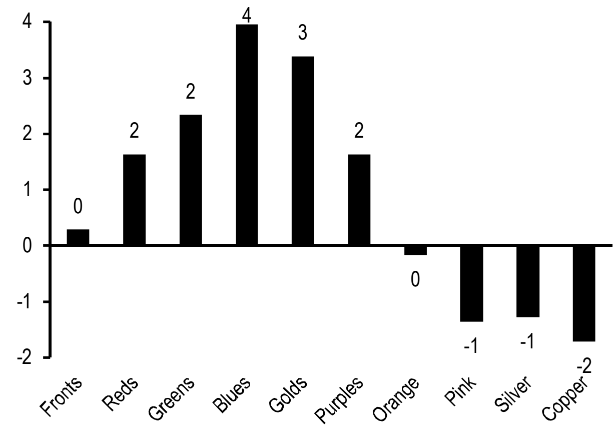
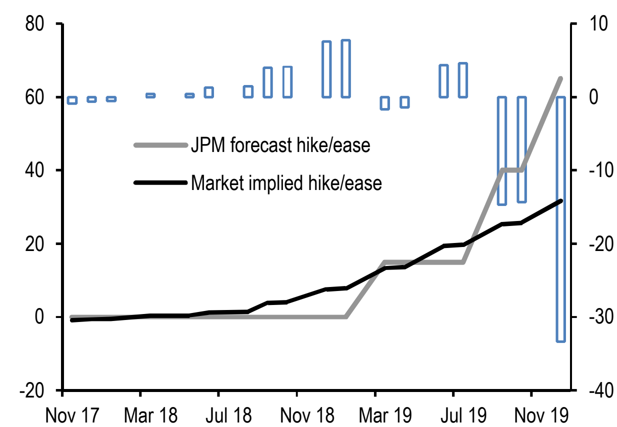


Exhibit 2: After the recent repricing we believe that the first hike in Mar19 is more properly priced but the pace priced in remains too slow vs. our call: we close Sep18/Mar19 steepener but keep paying Dec19 ECB OIS outright
JPM forecast for ECB deposit rate, forward EONIA rates (both lhs) and difference between EONIA and JPM forecast (rhs); bp



Swap curve

Over the past week the swap and EONIA curves bear steepened with a modest underperformance of the intermediate sector. In terms of 1Y forwards blues and golds EONIA sold off the most in a relatively low volatile week (**Exhibit 1**). Flows were biased towards long-end receiving with still solid swapped issuance activity.

After the recent sell off we find valuations at the front end less stretched, with our call for a 15bp hike in the deposit rate for Mar19 almost fully priced in (Mar19 ECB OIS at -21.7bp). In details, **looking at the forward EONIA curve vs. our forecast for the path of the deposit rate we make the following considerations**.

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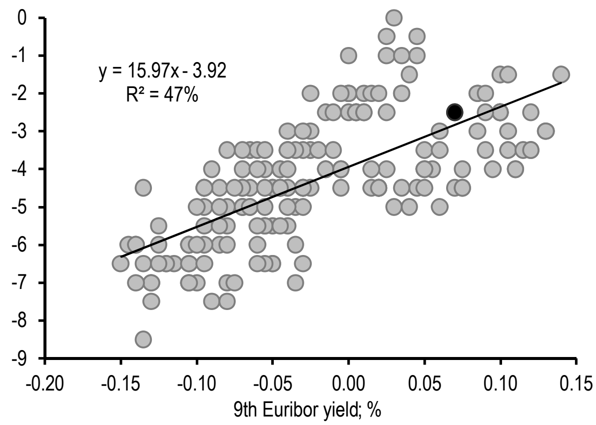
Exhibit 3: Close short in the body of the Dec18/Dec19/Dec20 Euribor fly

5th/9th/13th 50:50 Euribor fly regressed against 9th Euribor yield; since 1 Jan 2017; bp



First, the short end (12M to 18M) of the EONIA curve is broadly fairly priced with 13bp priced in for March 2019. **Second**, the sub-1Y EONIA rates are pricing some probability of tightening by Q3 next year (4bp by Sep18), which we deem being highly unlikely given risk around our baseline call for QE extension and strong conviction on ECB not changing the sequencing. **Third**, the cumulative amount of tightening priced further out the curve appears too modest vs. our baseline call (**Exhibit 2**).

Strategy wise, we believe that there is still some upside in our long-standing Sep18/Mar19 ECB OIS curve steepener. However, with market almost fully pricing the 15bp hike and limited upside in long position at the very front end (4bp) **we tactically close Sep18/Mar19 ECB OIS curve steepener**. We see risks biased for a later start and **we have stronger conviction in paying Dec19 ECB OIS outright which is pricing only about 30bp of hike**. We target a cumulative of 35-40bp to close the trade.

As a medium term bearish trade with expected positive convex profile **we have been recommending selling Dec19 in the Dec18/Dec19/Dec20 50:50 Euribor fly** (**Exhibit 3**). We believe that the fly has more upside if the sell off continues. However, around -3bp we see risks more symmetric, and given the carry of the position has now turned marginally negative **we tactically close the trade**. We have a bias to roll the position into the Mar19/Mar20/Mar21 fly but wait for better entry level at around -5bp.

Exhibit 4: We have a bias to pay 10Y in the 5s/10s/30s 50:50 EUR swap fly as medium term bearish trade

5s/10s/30s 50:50 swap fly regressed against *1)* 10Y swap yield and *2)* ECB QE dummy; past 5Y; bp

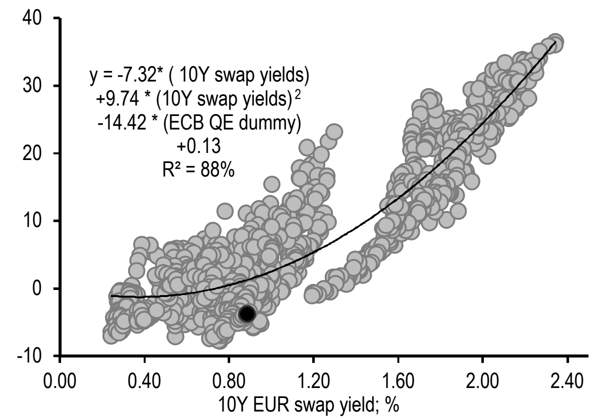
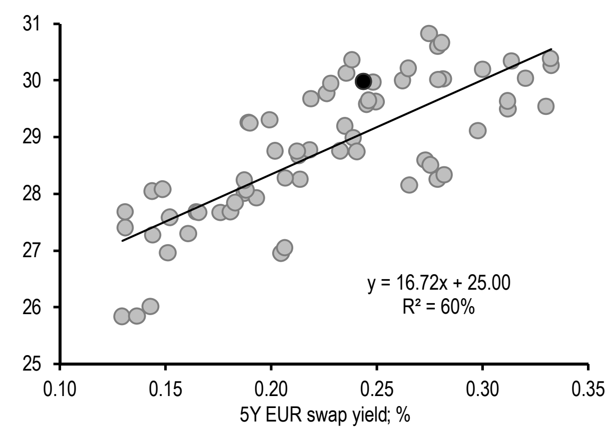


Exhibit 5: Keep the EUR steepening bias and hedge risk of intermediates underperformance via 2s/5s weighted bear steepener

2s/5s weighted* curve regressed against 5Y EUR swap yields; past 3M; bp



* Weighted curve defined as: 0.55*5Y - 2Y.

On the swap curve the modest underperformance of the intermediate sector has resulted in the cheapening of the body in various swap flies. In our long term fair value model, **we find 10Y marginally expensive in the 5s/10s/30s swap curve**, after adjusting for the QE-expectation driven dynamic between Draghi's Jackson Hole speech in August 2014 and the ECB meeting in January 2015 (**Exhibit 4**). **As a medium term bearish trade with an expected positive convex profile we have a bias to pay 10Y in the 5s/10s/30s 50:50 EUR swap butterfly**. However, given our medium term

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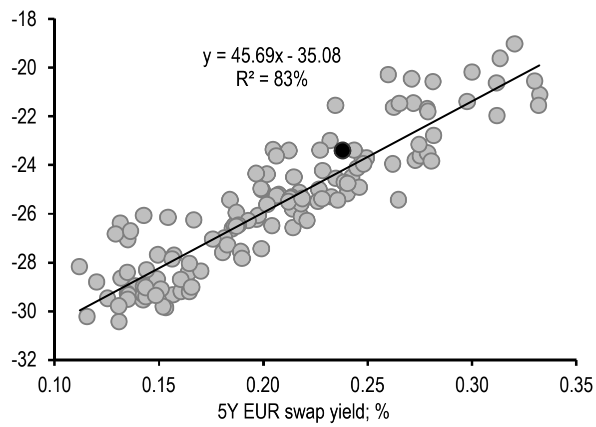
Exhibit 6: 5Y underperformed on the curve on the recent sell off and we see risk of further underperformance in a bearish move: keep OTM 2s/5s/10s bear belly cheapener

2s/5s/10s 50:50 EUR swap butterfly regressed against 5Y EUR yields; past 6M; bp



bearish duration stance and the negative carry (about 2bp over 3M), we refrain from entering the trade.

In terms of conditional trades, one of the risks highlighted last week when we closed Schatz/Bund weighted bear steepener was an underperformance of the intermediate sector, which could change the recent empirical directionality of the German and Euro curve. While in our view the ECB will not change sequencing we believe that 5Y could reprice if the sell off continues and as conditional trade **we recommend 2s/5s weighted bear steepener**. The 2s/5s curve weighted by the ratio of implied volatility (55%) is directional to the level of 5Y yield and is expected to steepen in a sell off (**Exhibit 5**). Even though the RV is modestly against the trade with the weighted curve a touch too steep, we still find the trade attractive.

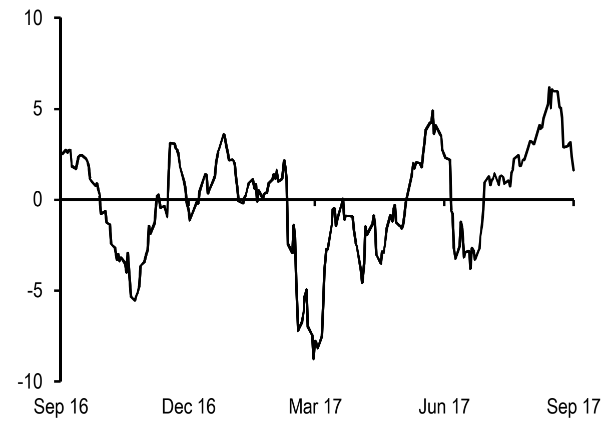
As medium term bearish trade **we also keep 2s/5s/10s conditional bear belly cheapener** that we initiated 3M ago with 6M payers. 5Y underperformed recently on the fly and corrected some of its earlier richness on the curve, but is expected to underperform further if the sell off continues (**Exhibit 6**).

As a bullish hedge **we also keep 3s/30s weighted bull flattener we initiated last week**. The residual of the weighted curve has partially corrected but it still remains a touch too steep vs. yield levels (**Exhibit 7**).

In RV space we highlight that 15Yx5Y is now trading fair vs. surrounding 5Y forwards and **we remove our bias for receiving the body of the**

Exhibit 7: The 3s/30s weighted curve is marginally less steep vs. level of 30Y yields: we still hold 3s/30s weighted bull flattener

Residual 3s/30s weighted* curve regressed against 30Y EUR swap yields; past 1Y; bp

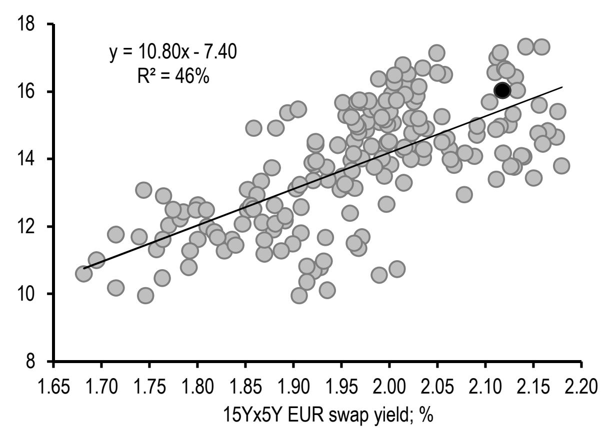


* Defined as 0.51*30Y - 3Y.

Reg equation: Y = 28.4*X + 36.3; R2 = 80%; SE = 2.9bp.

Exhibit 8: 15Yx5Y is trading fair on the curve vs. surrounding 5Y forwards: we remove our bias for receiving 15Yx5Y in the level neutral fly

10Yx5Y/15Yx5Y/20Yx5Y 50:50 EUR swap butterfly regressed against 15Yx5Y; since Jan 2017; bp



10Yx5Y/15Yx5Y/20Yx5Y the level neutral fly (**Exhibit 8**).

Special focus: Money market and benchmark reform, a new index from the ECB

Over the past few weeks we have seen increasing interest from clients in discussing the upcoming EONIA reform with potential implications on the level of the fixings. Based on monetary policy considerations we believe that the **ECB will be biased to have EONIA fixings within the refi/deposit rate corridor** and therefore we

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Exhibit 9: Euribor and EONIA benchmark reforms are at different stages; our bias is that a condition for the EONIA reform to move forward would be a limited impact on fixings

Summary of progress of reform on Euribor and EONIA benchmarks

Euribor:

- Reform the existing benchmark to anchor it to transactions instead of quotes
- This May EMMI concluded that "under the current market conditions it would not be feasible to evolve to a fully transaction-based methodology following a seamless transition path"
- Feasibility of a hybrid model being explored. Task force established to gather feedback from market participants and guidance on new methodology

EONIA:

- First phase of defining a governance framework compliant with the new regulatory requirements concluded
- Second phase (Data analysis exercise) undertaken to ensure that the benchmark's design is adapted to the economic reality it intends to capture

Exhibit 10: The ECB has started the process for the determination of a new risk free unsecured overnight rate raising questions about long term cohabitation with EONIA

Summary of ECB's intent and timeline to publish a new unsecured overnight interest rate

Reason for developing a "risk free interest rate"	Both of the current benchmarks rely on the voluntary contributions of two distinct panels of banks with repercussions for financial stability that could result from the absence of a reliable private benchmark.
	The new overnight rate is intended to serve as a backstop
	The money market statistical reporting (MMSR), which will form the basis for the ECB's overnight rate, offers the option of taking into account transactions between the reporting agents (banks) beyond the interbank market
Timeline	The high-level features will be communicated to market participants in the course of 2018
	The new overnight interest rate is intended to be produced before 2020
Calculation method	The new overnight interest rate will be launched on the basis of the 52 reporting banks (with a possible extension) fulfilling the criteria specified in the current MMSR regulation
	The methodology of the ECB's new rate will be defined later, but should rely on individual transactions rather than on a single contribution per bank

Source: ECB

anticipate only a modest downward bias to EONIA fixings (around 2bp) in case the reform is put forward. The inclusion of transactions of non-Euro based investors who do not have access at the ECB could create a downward bias, as there are Euro area investors who currently do not have access to the ECB facilities and are forced to park Euro in unsecured transactions that trade below EONIA or below deposit rate (as seen by current level of EURONIA at -46bp). However, we believe that the ECB will may not like the widening of the definition which will warrant large deviation from current level of fixings.

Additionally, there is some anecdotal evidence that deposit of corporates in the Euro banking system are occurring at levels different from the interbank market, as some banks are unwilling to pass through negative rates. An inclusion of these deposits in an enlarged EONIA definition could actually give a bias to higher fixings. Putting it all together **we believe that the overall impact of an EONIA reform on the level of fixings is likely to be modest for the reform to move forward**. With the ongoing reform on Euribor and EONIA benchmarks to bring both benchmarks into compliance with the new EU Regulation on benchmarks, we summaries the progress of the reform on these benchmarks in **Exhibit 9**.

On Thursday, the FSMA, ESMA, the European Central Bank and the European Commission announced the launch of a new working group tasked with the identification and adoption of a "risk-free overnight rate". **Exhibit 10** summaries the intent and expected timeline for implementation of the new "risk-free overnight rate".

We note that the new overnight interest rate would be different to EONIA in a number of ways. **First,** it would rely on individual transactions rather than on a single contribution per bank. **Second**, EONIA is based on voluntary data by 28 panel banks whereas the new rate will depend on daily submission of banks reporting under the MMSR regulation. **Third**, EONIA is administrated by the private sector while the ECB's new overnight rate will be administrated by the Eurosystem. ECB notes that the future of current benchmarks is hard to predict and the initiative is intended to complement existing benchmarks and serve as a backstop to market initiatives.

While the creation of the new benchmark appears to be a slow process with the ECB indicating that the new benchmark is expected to be produced before 2020, one question arising from clients is around the possible cohabitation of the two indices, EONIA and the new ECB unsecured overnight rate. The ECB acting as agent behind the new benchmark index could create a bias for the new ECB unsecured overnight rate to prevail over the long run. However we believe that some liquidity is needed to be built in term of derivatives market to create an organic growth which could lead to the new curve

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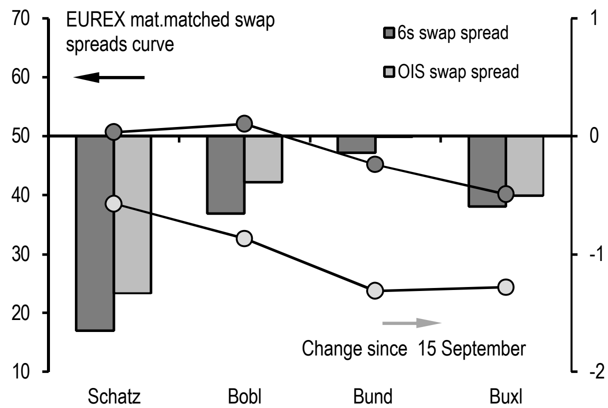
Exhibit 11: Swap spreads narrowed across the curve with a notable outperformance of Bobl and Bund swap spreads

Current level of Dec17 Schatz, Bobl, Bund, and Buxl maturity matched 6s and OIS swap spreads and change since 15 September; bp



becoming the discounting curve of EUR derivatives portfolio.

Swap spreads

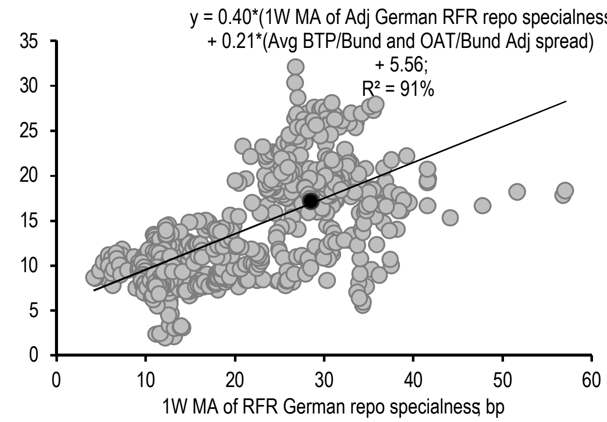
Over the past week swap spreads exhibited moderate volatility narrowing broadly across the curve with a notable outperformance of intermediate and long-end swap spreads. Flows were driven by decent amount of both swapped issuance activity and macro receiving in the belly of the curve which contributed to the relative outperformance of Bobl and Bund vs. Schatz and Buxl swap spreads (**Exhibit 11**).

While holding a medium term widening bias on Schatz swap spread and **we have refrained from holding outright Schatz swap spread exposure since 1st September on valuations**. Schatz swap spread has retraced from its peak around mid-September and no longer appears too wide vs. fundamental drivers (**Exhibit 12**).

Our medium term outlook is unchanged. We believe that the continuation of ECB purchases, albeit at a lower pace will still richen funding rates across the German curve, leading to wider short-end and intermediate swap spreads. We discussed in a separate note our outlook on the repo market.[17] The main conclusion from the analysis of banks' balance sheets is that **repo netting efficiency has reduced broad based balance sheet scarcity, but at the same time QE-driven German scarcity will persist, leading to richening of funding rates**.

Exhibit 12: Schatz swap spreads are no longer rich and now appears broadly fair vs. fundamental drivers such as German repo specialness and intra-EMU spreads

Front* Schatz swap spreads regressed against *1)* 1W MA of RFR Germany adjusted** repo specialness, *2)* average of 10Y OAT/Bund b/m spread and 10Y BTP/Bund b/m spread after the US Presidential election and 0 otherwise; since January 2015; bp



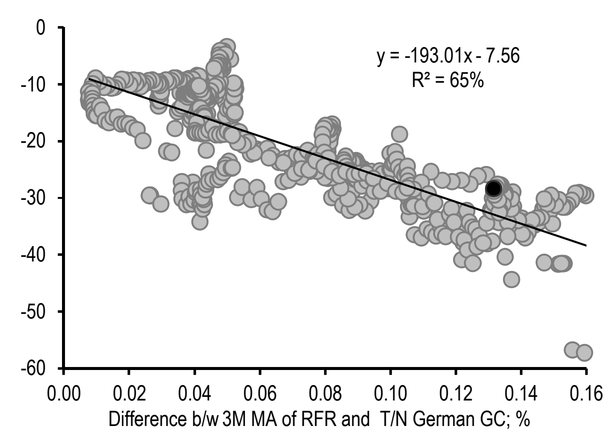
* Futures rolled on the 1st of the delivery month.

** Excluding year-end effect from 23 December 2016 to 6 January 2017. Repo Funds Rate Germany (RFR Germany) is a daily euro repo index calculated from trades executed on the BrokerTec and MTS electronic platforms. All eligible repo trades are centrally cleared and RFR Germany is calculated and published by ICAP Information Services. RFR Germany is calculated with repo trades that use German sovereign government bonds.

RFR Index source: Broker Tec and MTS trading platforms.

Exhibit 13: The widening between the RFR German repo index and General Collateral rate for Germany should drive funding rates lower supporting wider front end swap spreads

RFR Germany expensiveness versus EONIA regressed against difference between 3M MA of RFR and 3M MA of T/N German GC; since January 2013; bp



[17] See *Update on the repo market in Euro ahead of QE tapering* by Fabio Bassi, 21 Sep 2017.

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Exhibit 14: We keep a medium term widening bias in Schatz swap spread on the back of funding pressure; however we wait for better entry level around 35-36bp vs. OIS to initiate widener

Statistics of Schatz OIS swap spread widener recommendations in 2017; bp

Schatz OIS swap spread widener	Entry		Exit		PnL
	Date	Level	Date	Level	
Mar-17	06-Jan-17	37.8	03-Feb-17	43.0	5.2
Sep-17	12-May-17	36.6	02-Jun-17	41.6	5.0
Sep-17	16-Jun-17	35.0	04-Aug-17	37.0	2.0
Dec-17	18-Aug-17	36.0	01-Sep-17	39.5	3.5
Average		36.4		40.3	3.9

In addition to the long term positive relationship between ECB purchases and richness of German repo, we also find that the expensiveness of RFR German repo index is also driven by **the spread between the RFR German repo index and General Collateral repo rate of German paper** (**Exhibit 13**). The widening since early this year, when QE purchases became more distributed across the curve suggests a broad based richening of German repo rates across the curve with fewer bonds trading at GC, a sign of increasing funding pressure although less acute than towards the end of last year.

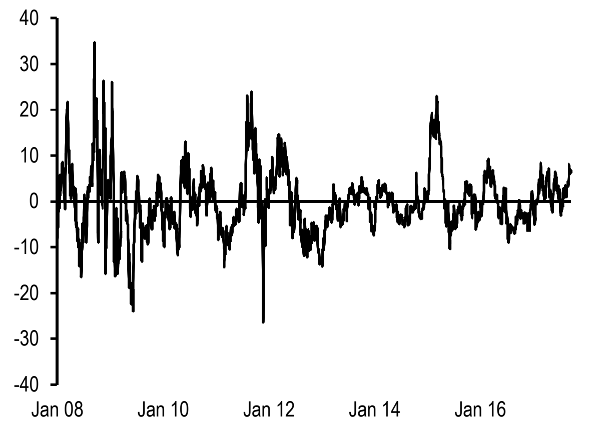
The other factor supporting wider Schatz swap spread is our medium term widening outlook in peripheral spreads. However, with a lighter peripheral portfolio (see *Euro Cash*) ahead of more clarity on the Italian electoral law reform, we do not find current valuations attractive and **we target 35-36bp in Dec17 Schatz OIS swap spread to re-enter outright widener** (**Exhibit 14**).

At the long end of the curve our valuation model still suggests that 10Y German b/m swap spreads are trading 7bp too wide vs. fundamental variables after adjusting for sovereign QE, although the residual has partially declined over the past few weeks (**Exhibit 15**). In the past two weeks we have been running an outright Bund OIS swap spread narrower on the back of valuations, expected increased in swapped issuance and as a proxy of short duration position. We find Bund swap spread narrower to be less attractive now as Bund yields are hovering around the middle of the last 3M range, muted directionality in a sell off and swapped issuance activity. Thus, **we tactically take 1bp profit in our recommended Dec17 Bund OIS swap spread narrower**.

The more muted directionality in the recent sell off suggests some latent geopolitical risk and positions are likely skewed into narrowers (Exhibit 16).

Exhibit 15: 10Y German b/m swap spreads are trading 7bp too wide vs. fundamental drivers and 3M of weekly QE purchases to adjust for the QE effect

Residual from regressing 10Y German swap spreads against *1)*1Yx3M EONIA yield, *2)* 20D MA of swapped issuance*, *3)* 3Mx10Y EUR swaption implied volatility, *4)* 10Y wtd peripheral spread** and *5)* 3M MA of weekly ECB purchases (PSPP+ABSPP+CBPPs+CSPP); since 1 Jan 2008; bp



* We use fixed-rate, euro-denominated issuance by financial institutions (including covered bonds) and supras/agencies, plus one-half of corporate bond issuance, as an indicator of potential swapped issuance

**10Y weighted peripheral spread computed against Germany for Ireland, Portugal, Italy and `Spain (weighted by the size of their outstanding bond market).

Reg equation:

Y = 8.87*(1Yx3M EONIA) – 1.09*(20D MA of swapped issuance)-15.83*(3Mx10Y imp vol) + 1.64*(3Mx10Y imp vol)^2 + 3.21*(10Y peri spread) +0.79*(10Y peri spread)^2 +1.50*(3M MA of the ECB purchases, in €bn) +49.36; R^2 = 71%; SE = 7bp.

Exhibit 16: The negative directionality of Bund swap spreads in the recent sell off has been more muted than the widening seen in the geopolitical-FTQ rally of the past few weeks, suggesting latent geopolitical risk and positions likely skewed into narrowers

Weekly change in CTD spot yield and weekly change in front Bund invoice swap spread (2W changes around the rolling period); past 6W

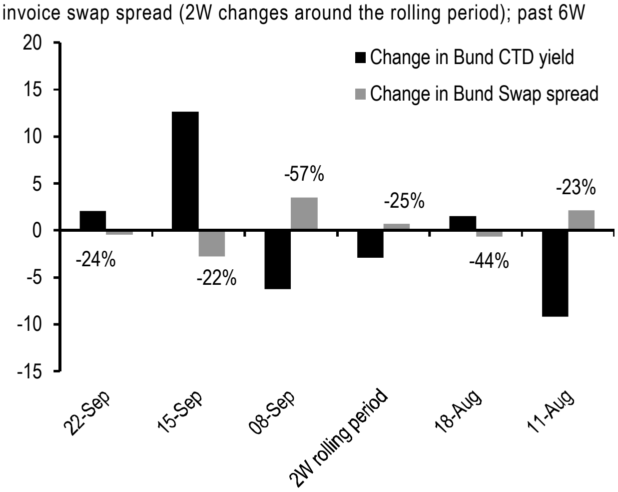


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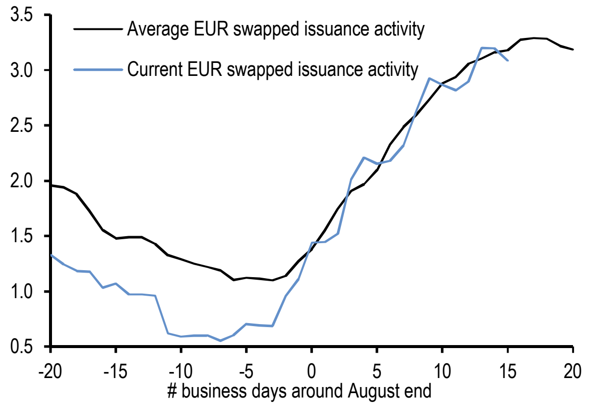
Exhibit 17: Swapped issuance activity increased in September in line with historical patterns and is expected to stabilise at current levels before softening

20D MA of EUR swapped issuance activity* and 10Y German benchmark maturity matched swap spread around end of August; since 2010; €bn/day



* See Exhibit 15 for details.

Although we typically anticipate a stronger negative directionality in rallies than in sell-offs, we were expecting that some unwind of the flight-to-quality trades of late August/early September would keep strong directionality also in sell offs. We read the lower negative beta as an indicator that swap spread narrowers positions, especially in the 10Y sector, may be crowded.

The dynamic of swapped issuance activity over the last few days has remarkably been in line with the typical seasonality, with daily issuance in September increasing from less than €1bn to over €3bn (**Exhibit 17**). From current levels we expect issuance to remain stable over the short term and a decline in the next few weeks. Therefore, **we no longer see the swap issuance activity as a strong argument to hold swap spread narrowers**.

We still keep a medium term strategic swap spread Dec17 Schatz/Bund swap spread curve flattener on the back of valuations and expected funding pressure in the short-end to intermediate factor. In addition we find that current level of the swap spread curve is a touch too steep vs. the level of Schatz swap spread (**Exhibit 18**).

In terms of RV further out the curve, we note that the recent outperformance of Bobl swap spread has removed its previous cheapness and now appears fair in the Schatz/Bobl/Bund swap spread fly. While RV is no longer attractive, **we keep a mild bias for wider Bobl swap spread in the Schatz/Bobl/Bund swap spread fly** under the view that these funding pressures will be more likely felt at the front-end and intermediate sector, given Bundesbank purchases (**Exhibit 19**).

Exhibit 18: The swap spread curve appears too steep vs. the level of Schatz swap spread: keep Dec17 Schatz/Bund swap spread (vs. 6) curve flattener

Schatz/Bund invoice swap spread curve regressed against Schatz invoice swap spread; past 1Y; bp

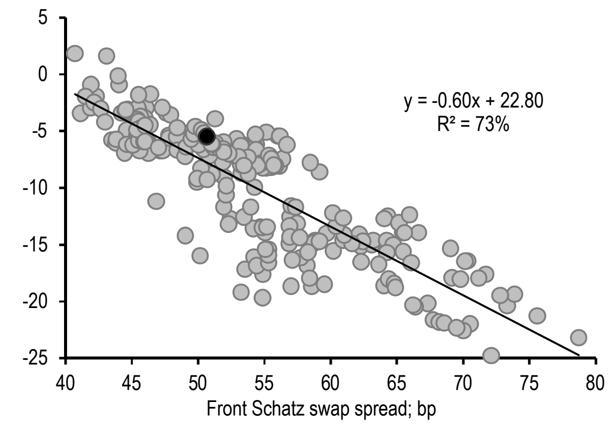


Exhibit 19: Bobl swap spread has outperformed on the curve and is now trading broadly fair (from too narrow) in the Schatz/Bobl/Bund swap spread fly. We still have a bias for Bobl swap spread outperforming in the fly

Schatz/Bobl/Bund invoice swap spread fly regressed against Bobl invoice swap spread; past 1Y; bp

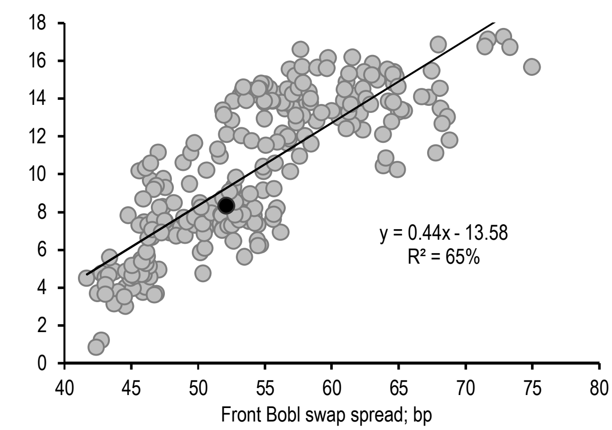


Exhibit 20: The breakeven of our OTM Dec17 Bund bull widener suggest a 30% negative directionality of swap spreads to yield: empirical evidence suggests a more negative directionality in FTQ episodes

Current and breakeven level for CTD invoice yield and swap spread;

	Level/Strike	CTD Strike Yield (%)	Swap spread (bp)
Current Bund	161	0.34	44.7
Our trade	164	0.13	51.1
Difference (bp)		21	6.4
Implied directionality		30%	

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Exhibit 21: Implied volatility was broadly unchanged across the surface over the past week

Current, 1W ago (left axis) and 1W change (right axis) in implied volatility for various EUR 3M expiry swaptions; bp/day

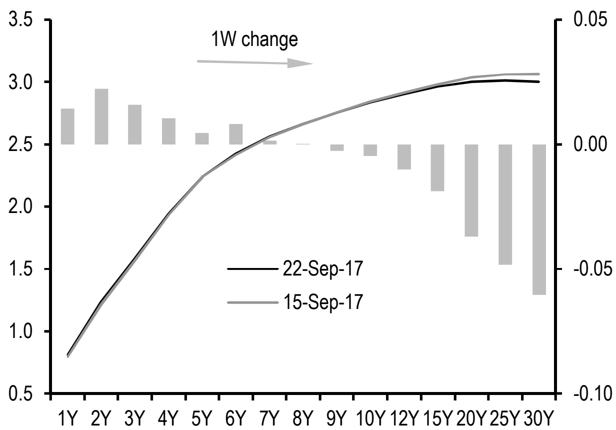
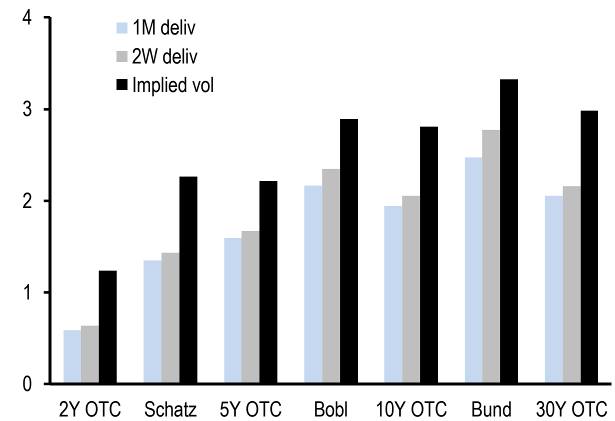


Exhibit 22: Delivered volatility is low and well below corresponding implied volatilites

Current implied vol and 2W & 1M delivered volatility of underlying yields; bp/day



To hedge against geopolitical risk **we hold OTM Dec17 Bund swap spread bull widener**. After the recent dynamic (narrowing of swap spread in a sell off) the breakeven of our recommendations is 6.4bp wider than current levels on a 21bp sell off, implying 30% directionality (**Exhibit 20**). Empirical evidence suggests a more negative directionality in FTQ episodes and we hold the trade.

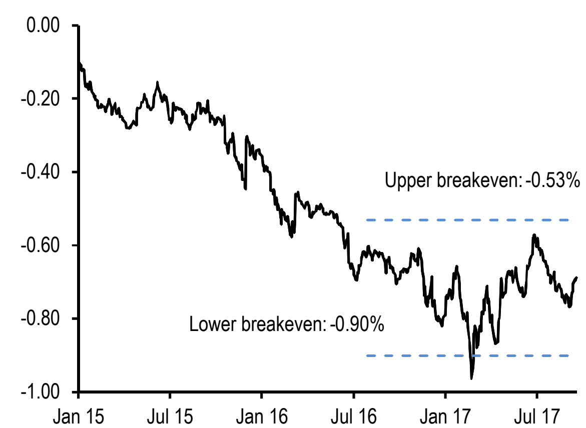
Euro volatility

Implied volatility curve was broadly unchanged over the week, in line with modest changes in the swap curve (**Exhibit 21**). 3Mx10Y is at 2.8bp/day which is about 0.3bp/day above its historic lows reached in late July but still well below its historic averages. Similarly, 3Mx30Y implied has hovered around 3bp/day over the past few days. 1M delivered volatility was also roughly unchanged across the curve. There was a marginal more volatility in implied on listed options on Bond futures with Schatz, Bobl, and Bund implieds declining 0.1bp/day, 0.1bp/day, and 0.2bp/day, respectively.

Delivered volatility continues to hover well below the current implied volatility levels, with the difference between the two largest for Schatz (**Exhibit 22**). We continue to stay short vol at the front end of the curve and **hold shorts in 112.1/111.9 Dec17 Schatz unhedged strangles**. As we have discussed in the past, lack of expectation around any ECB action with respect to policy rates, despite the apparent global shift towards hawkish central bank rhetorics, is likely to keep Schatz yield anchored. In our view, the recent few bps of sell off in Schatz yield is not the onset of a full blown repricing of ECB expectations - the EONIA curve is still pricing 7bp

Exhibit 23: Stay short Schatz gamma and hold 112.1/111.9 Dec17 unhedged Schatz strangle

2Y Schatz b/m bond yield versus breakeven levels; since Jan 2015; %



of hike by Dec2018 and 31bp by Dec2019. To be sure, we have a short duration view on Dec19 ECB OIS but we expect less than 15bp sell off in Schatz yield from current levels. In the near term, we remain comfortable of the view that Schatz yield will remaining well within the trade breakeven ranges of (-0.90%,-0.53%) (**Exhibit 23**).

We highlight that ahead of the Italian elections early next year we may see some risk aversion demand in Schatz. However, we believe that the experience of sharp rally in Schatz yield on the back of demand driven by redenomination risk seen before the French election is unlikely. Additionally, our trade expires on 24 November 2017 and we believe that the Italian elections are unlikely to come into focus that early given that the electoral laws are still not clear and our baseline remains

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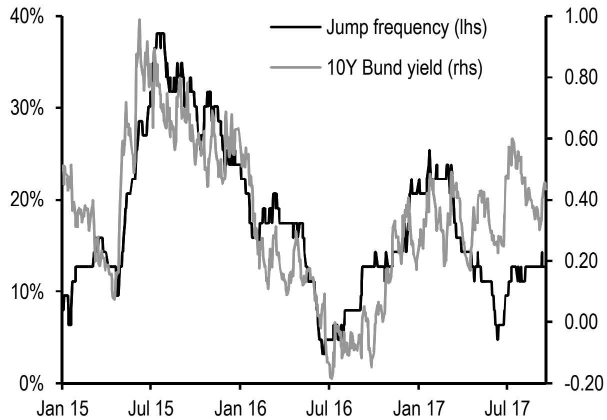
Exhibit 24: Low jump frequency in Bund yield is a challenge to long gamma positions

3M jump frequency* for 10Y German b/m bond yield (lhs) versus 10Y German b/m bond yield (rhs); since 1 Jan 2015; %



* Frequency defined as instances when the absolute daily change in 10Y German b/m bond yield was greater than 5bp. These number of instances are expressed as a percentage of the total number of days (63 in our case).

for the elections to be early next year (see *Euro Cash*). Finally, as we have discussed in the past that Italy exit risks itself are very low given legal hurdles which in itself would dampen any sharp rally. Overall, **we stay short Dec17 Schatz unhedged strangles**.

Investors who wish to fade the recent cheapening of Schatz yield could consider buying 1x2 112.3/112.1 Dec17 call spreads at close to flat (Dec17 Schatz futures at 112.1). The equivalent yield range is -0.78% / -0.68% which makes the lower breakeven to be around -0.88%. The OTM call is trading around 0.2bp/day above the ATM. However, we caution that the overall structure is currently modestly short delta implying at the trade would initially incur losses in a rally before the overall delta turns long in a few weeks (for comparison, the Nov17 1x2 call spread on the same strikes indeed has a positive delta).

At the long end of the curve, **we retain our bullish gamma bias in the 10Y sector**. Bund implieds at 3.3bp/day are close to their historic lows and are attractive to buy on valuations. However, as we mentioned earlier, delivered volatility is low. This can also be seen in the form of low jump frequency even though Bund yields have moved higher. In **Exhibit 24**, we plot the rolling frequency of changes of 10Y German benchmark bond yield over 5bp over the last 3M versus 10Y Bund yield. Historically, the jump frequency typically exhibits a good correlation to the level of yields. However, jump frequency is now low even though yields have moved back up to around 0.45%. The drift higher in yields in the last few trading sessions has taken place in a more orderly fashion with limited frequency of high delivered volatility days. We do not expect this dynamic to change significantly over the next few days. The ECB meeting is still four weeks away and with the FOMC out of the way, event risk is low over the very near term. This poses a risk to outright long volatility position.

Instead, **we hold Schatz/Bund vol curve steepener as a long gamma proxy** which is supportive on valuations and offers positive gamma carry (**Exhibit 25**). The implied volatility spread has increased from 0.7bp/day to 0.9bp/day and we expect this to increase further towards the 1.5bp/day level.

Exhibit 25: Instead we hold Schatz/Bund vol curve steepener which offers positive gamma carry with a target in the vol spread of around 1.5bp/day

Schatz/Bund implied volatility spread and 3M delivered volatility of 10Y Bund yield minus 2Y Schatz yield spread; past 5Y; bp/day

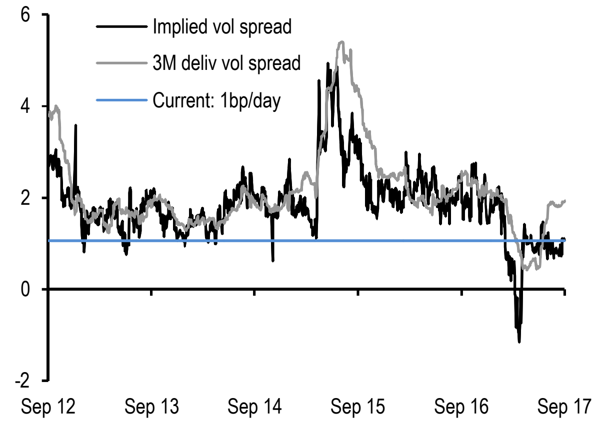


Exhibit 26: We highlight a selection of rich and cheap forward vol points

6M statistics on various forward volatility structures; bp/day

	Current	Average	Max	Min	Zscore
5Yx5Yx5Y	4.3	4.2	4.3	4.1	1.9
7Yx5Yx10Y	4.5	4.4	4.5	4.3	1.5
7Yx5Yx20Y	3.6	3.5	3.6	3.3	1.7
5Yx5Yx30Y	3.5	3.4	3.5	3.3	2.1
7Yx5Yx30Y	3.3	3.2	3.3	3.0	1.8
5Yx10Yx20Y	3.3	3.2	3.3	3.1	2.2
1Yx1Yx10Y	3.7	3.8	4.1	3.6	-1.2
2Yx1Yx20Y	3.8	3.9	4.0	3.7	-0.7
1Yx2Yx20Y	3.8	3.9	4.1	3.7	-1.2
1Yx1Yx30Y	3.7	3.8	4.1	3.6	-1.0

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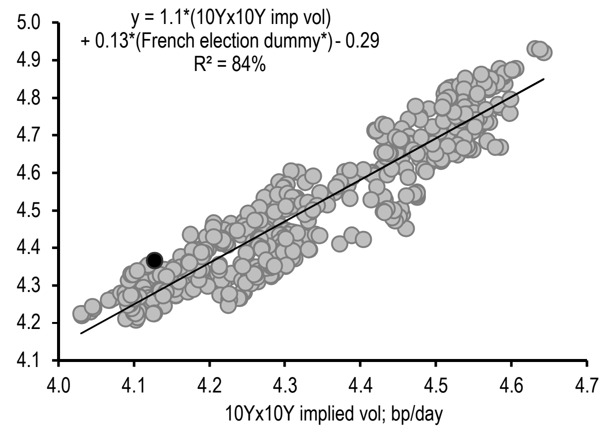
In vega space, **we recommended long vega positions in 10Yx10Y**. Since our recommendation, the implied volatility is broadly unchanged. However, the ATMF yield is about 15bp higher making the option away from ATM and reducing its vega exposure. **We close this trade at a small profit** (see *Trade Recommendations*).

Investors who wish to go short volatility at the long end, should consider forward volatility structures that are currently trading rich versus recent history (**Exhibit 26**). For instance, 7Yx5Yx10Y forward volatility (constructed using a triangle of swaption and assuming a correlation of 1) is currently trading 0.1bp/day rich versus 10Yx10Y implieds. The relationship has been very strong and the residual has exhibited a strong degree of mean reversion (**Exhibit 27**). Therefore, **we have a bias towards selling 7Yx5Yx10Y forward vol versus 10Yx10Y on RV considerations.**[18]

On a cross market basis, **we take profit in our long in Dec17 2Y UST put versus 2Y Schatz put**. The latest "Fed dots" still point towards another hike in 2017 which is in line with our view. However, with markets pricing in a greater than 60% probability of a 25bp hike at the December FOMC meeting and the IOR/2Y spread at its widest level over the past 3M, we see limited upside in our short 2Y UST view and are now neutral on 2Y UST duration. We would reconsider entering this trade if 2Y UST yield drops below 1.35-1.38% (currently around 1.43%). We also close our long standing long Dec17 Eurodollar put versus Euribor implemented using 1Y midcurve options at close to flat P&L.

Exhibit 27: For investors wishing to go short vega, we favour selling 7Yx5Yx10Y as it is trading rich versus other vega structures

7Yx5Yx10Y forward volatility regressed against 1) 10Yx10Y swaption implied vol and 2) French election dummy; past 2Y; bp/day



Trade recommendations

High-conviction trades are starred (★). All other recommendations are moderate-conviction

Swap Curve

- **Initiate 2s/5s weighted bear steepener**
  - Buy €55mn 3Mx5Y payers (55% risk, notification date 22 Dec 2017, maturity date 28 Dec 2022) versus selling €247.3mn 3Mx2Y payers (100% risk, notification date 22 Dec 2017, maturity date 28 Dec 2019) to enter into a premium neutral weighted 2s/5s bear steepener at 28.2bp versus forward level of 28.2bp and spot level of 30bp;
- **Close Sep18/Mar19 ECB OIS curve steepener**
  - Unwind longs in €100mn Sep18 ECB OIS swap versus paying €100mn Mar19mn ECB OIS swap to close a ECB OIS curve steepener at 9.1bp versus an entry level of 8.9bp; (GFIMS 21st July 2017); P&L since inception: +0.2bp of yield;
- **Take small profit in short Dec19 Euribor future in Dec18/Dec19/Dec20 50:50 Euribor fly**
  - Close shorts in 1000 Dec19 Euribor futures versus buying 500 Dec18 and Dec20 Euribor futures to close a belly cheapener at -3bp versus an entry level of -3.8bp(spread defined as 2*Dec19 - (Dec18 + Dec20)); (GFIMS 14th July 2017); P&L since inception: +0.4bp of yield;
- **Continue to pay Dec19 ECB OIS**
  - Continue to pay €100mn Dec19mn ECB OIS at -4.8bp versus an entry level of 6bp; (GFIMs 29th June 2017, rolled into outright in GFIMS 1st September 2017); P&L since inception: -10.8bp of yield;
- **Hold 3s/30s weighted bull flattener**
  - Buy €51.1mn 1.584% 3Mx30Y receivers (51.1% risk, notification date 15 Dec 2017, maturity date 19 Dec 20147) versus selling €790.7mn -0.003% 3Mx3Y receivers (100% risk, notification date 15 Dec 2017, maturity date 19 Dec 2020) to remain in a weighted 3s/30s bull flattener at 81.3bp versus forward and spot level of 80.9bp and 85bp (weighted spread defined as 0.511*30Y - 3Y); (GFIMS 15th September 2017); P&L since inception: +3.9bp of notional;

[18] To sell the 7Yx5Yx10Y forward vol using a triangle of swaptions, sell 12Yx10Y and 7Yx5Y swaption straddles and buy 7Yx15Y swaption straddles. The overall trade also involves buying 10Yx10Y straddles.

- **Hold reds/blues weighted bull flattener**
- Buy €49mn 0.459% 3Mx(3Yx1Y) midcurve receivers (49% risk, notification date 6 Nov 2017, midcurve start date 8 Nov 2020, term 8 Nov 2021, 3s basis) versus selling €99.6mn -0.092% 3Mx(1Yx1Y) midcurve receivers (100% risk, notification date 6 Nov 2017, midcurve start date 8 Nov 2018, term 8 Nov 2019, 3s basis) to remain in reds/blues weighted bull flattener at 31.7bp versus forward level of 35.1bp and spot spread of 34bp. Weighted spread is defined as: 0.49*(3Yx1Y) - (1Yx1Y); (GFIMS 4th August 2017); P&L since inception: -2.8bp of notional;

- **Hold 2s/5s/10s bear belly cheapeners using 6M payers**
- Buy €100mn 0.41% 6Mx5Y payers (notification date 29 Dec 2017, maturity date 3 Jan 2023) versus selling €123.6mn -0.031% 6Mx2Y payers (notification date 29 Dec 2017, maturity date 3 Jan 2020) and €26mn 0.98% 6Mx10Y payers (notification date 29 Dec 2017, maturity date 3 Jan 2028) to remain in a bear belly cheapener at -12.9bp versus forward and spot level at -21.1bp and -23.4bp, respectively. Spread defined as 2*5Y - 2Y - 10Y; (*Minor twists to our H2 Outlook portfolio post Draghi's speech and Carney's shuffle*, 29th June 2017); P&L since inception: -4.3bp of notional;

Swap spreads

- **Take profit in Dec17 Bund OIS swap spread narrower**
- Close shorts in 1000 Dec17 Bund futures versus receiving €161.5mn CTD maturity matched EONIA swap (swap start date 12 Dec 2017, maturity date 15 Aug 2026) to take profit in a Bund OIS swap spread narrower at 24.2bp versus an entry level of 25.5bp; (*GFIMS* 8th September 2017); P&L since inception: +1.3bp of yield;

- **Hold Dec17 Schatz/Bund Euribor swap spread curve flattener**
- Sell 1000 Dec17 Bund futures versus receiving €162mn CTD maturity matched Euribor swap (swap start date 12 Dec 2017, maturity date 15 Aug 2026) versus buying 7030 Dec17 Schatz futures versus paying €787mn CTD maturity matched Euribor swap (swap start date 12 Dec 2017, maturity date 15 Sep 2019) to remain in a Dec17 Schatz/Bund swap spread curve flattener at -5.6bp versus an entry level of -5.1bp; (*GFIMS* 18th August 2017); P&L since inception: +0.5bp of yield;

- **Hold Dec17 OTM Bund bull widener**
- Buy 1000 164 Dec17 Bund calls (Dec17 Bund futures at 161.86) versus selling €167.2mn 0.635% CTD maturity receivers (notification date 24 Nov 2017, swap start date 12 Dec 2017, swap end date 15 Aug 2026) to remain in Dec17 Bund bull widener at 50.5bp versus forward at 45bp; (*GFIMS* 1st September 2017); P&L since inception: +1.5bp of notional;

- **Keep receiving 2Yx2Y EUR/USD cross currency basis**
- Receive €100mn 2Yx2Y EUR/USD cross currency basis (swap start date 28 Feb 2019, swap maturity date 1 Mar 2021) at -34.5bp versus an entry level of -40bp; (*GFIMS* 24th February 2017); P&L since inception: -5.5bp of yield;

- **Hold Reds/5Yx5Y EUR/USD cross currency basis curve steepener**
- Pay €100mn 5Yx5Y EUR/USD cross currency basis (swap start date 1 Sep 2022, swap maturity date 1 Sep 2027) versus receiving €482.8mn 1Yx1Y (reds) EUR/USD cross currency basis (swap start date 1 Sep 2018, swap maturity date 1 Sep 2019) at -7.2bp versus an entry level of -6.2bp; (*Cross currency basis 4Q17 Outlook* 30th August 2017); P&L since inception: -1bp of yield;

EUR Volatility

- **Take profit in 10Yx10Y vega**
- Close longs in €100mn 2.042% 10Yx10Y straddles (notification date 11 Aug 2027, maturity date 12 Aug 2037) at 4.1bp/day. This trade requires active delta hedging; (GFIMS 11th August 2017); P&L since inception: +8bp of notional;

- **Stay short 112.1/111.90 Dec17 Schatz unhedged strangles**
- Sell 1000 112.1 Dec17 Schatz calls and 111.90 Dec17 Schatz puts (Dec17 Schatz futures at 112.05) at 17.5cents versus an entry level of 27cents; (GFIMS 11th August 2017); P&L since inception: +9.5bp of notional;

- **Hold Dec17 Schatz/Bund vol curve steepener**
- Buy 1000 162 Dec17 Bund straddles (Dec17 Bund futures at 161.86) versus selling 5330 112.2 Dec17 Schatz straddles (Dec17 Schatz futures at 112.16) to remain in a vol curve steepener at 0.8bp/day versus an entry level of 0.7bp/day. The trade is structured to be gamma-neutral at inception and requires daily delta-hedging; (*GFIMS* 1st September 2017); P&L since inception: -2.4bp of notional;

- **Hold 15Yx15Y ATMF/ATMF+50bp payer spread**

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– Stay long €100mn ATMF/ATMF+50 15Yx15Y payer spread (ATMF strike 1.69%, notification date 31 Mar 2032, maturity date 2 Apr 2047) at 251.1cents versus entry level of 230cents (*GFIMS* 31st March 2017); P&L since inception: +21.1bp of notional;

Cross Market

- **Take profit in long Dec17 2Y UST OTM put versus 2Y Schatz puts**

– Close longs in 1000 107.75 Dec17 2Y UST puts versus selling 1552 111.90 Dec17 Schatz puts to take profit in a cross market yield spread widener at 220bp CTD forward yield spread of 221.8bp; (*GFIMS* 15th September 2017); P&L since inception: +2cents

- **Close at flat Dec17 1Y Euro$ midcurve put vs Euribor**

– Unwind longs in 454 97.875 Dec17 1Y Eurodollar midcurve puts (45.4% risk) versus selling 947 100 Dec17 1Y Euribor midcurve puts (100% risk) to close in a weighted cross market conditional bear widener at 96.4bp versus forward level at 104bp. The weighted curve is defined as 0.454*Dec18 Euro$ - Dec18 Euribor; (*GFIMS* 3rd March 2017); P&L since inception: 0bp of yield;

– * P/L for open trades calculated using Thursday's closes. New and closing trades are priced as of 1PM on non-payroll Fridays and 2PM on payroll Fridays.

Trades closed over the past 12 months

TRADE	ENTRY	EXIT	P&L
DURATION			
Pay Sep17 ECB OIS	30-Sep-16	14-Oct-16	4.0
Long 2Yx1Y EONIA	15-Nov-16	10-Feb-17	1.0
Long Oct18 ECB OIS	20-Jan-17	24-Feb-17	4.9
Long Jun18 ECB OIS	03-Mar-17	31-Mar-17	0.6
Long Mar18 ECB OIS	07-Jul-17	21-Jul-17	4.1
Long Dec18 ECB OIS	29-Jun-17	01-Sep-17	11.0
CURVE			
Pay 2Yx2Y real EONIA beta wtd against nominal	09-Sep-16	14-Oct-16	2.4
Reds/Greens EONIA curve steepener	24-Jun-16	14-Oct-16	-0.5
Pay 5s/10s/20s EUR swap fly	18-Mar-16	14-Oct-16	-5.5
Pay 2Yx2Y real EONIA beta wtd against nominal	21-Oct-16	28-Oct-16	5.5
Receive reds in fronts/reds/greens crv neutral fly	21-Oct-16	04-Nov-16	1.3
Pay 5Yx5Y vs. surrounding forwards	14-Oct-16	04-Nov-16	1.7
Reds/golds level neutral EONIA curve steepener	21-Oct-16	02-Dec-16	1.4
Greens/15Y swap curve steepener	09-Dec-16	20-Jan-17	13.5
Pay 15Yx5Y versus surrounding 5Y forwards	14-Oct-16	03-Feb-17	2.0
2Yx2Y/15Yx5Y swap curve steepener	20-Feb-17	24-Mar-17	-15.6
6Mx1Y/5Yx1Y EONIA level adj steepener	10-Mar-17	07-Apr-17	2.0
Dec17/Dec18 ECB OIS curve steepener	31-Mar-17	28-Apr-17	1.5
Sell Jun19 in Jun18/Jun19/Jun20 Euribor fly	24-Mar-17	05-May-17	0.4
Dec17/Dec19 ECB OIS curve steepener	28-Apr-17	29-Jun-17	6.7
Jun18/Sep18 ECB OIS curve steepener	31-Mar-17	07-Jul-17	1.0
Sell Sep19 in Sep18/Sep19/Sep20 Euribor fly	02-Jun-17	07-Jul-17	1.5
5Yx5Y/10Yx5Y steepener vs 10s/30s flattener	07-Jul-17	14-Jul-17	2.1
Dec18/Mar19 ECB OIS curve steepener	07-Jul-17	21-Jul-17	0.0
Reds/golds level adjusted flattener	16-Jun-17	21-Jul-17	-4.2
Oct17 Schatz/Bund weighted bear steepener	04-Aug-17	01-Sep-17	0.1
10s/30s bear steepener	16-Jun-17	01-Sep-17	1.5
Sep18/Mar19 ECB OIS curve steepener	21-Jul-17	22-Sep-17	0.2
Sell Dec19 in Dec18/Dec19/Dec20 Euribor fly	14-Jul-17	22-Sep-17	0.4
CONDITIONAL CURVE AND FLIES			
3s/20s weighted bull flattener	16-Sep-16	23-Sep-16	1.0
3s/7s/15s bear belly cheapener	08-Jul-16	10-Oct-16	-2.0
Dec17/Dec18 Euribor conditional bear steepener	12-Aug-16	14-Oct-16	0.0
2s/7s weighted bull flattener	14-Oct-16	04-Nov-16	0.5
2s/15s weighted bull flatteners using 3m receivers	04-Nov-16	09-Dec-16	-4.0
3s/20s weighted bear steepener	02-Dec-16	06-Jan-17	1.1
5s/10s/30s bull belly richeners	09-Dec-16	13-Jan-17	1.2
3s/7s/15s bull belly richener	28-Oct-16	20-Jan-17	0.0
5s/10s/30s bull belly richeners	27-Jan-17	10-Feb-17	2.3
1Y/Jun17 Bobl bull falttener	10-Feb-17	24-Feb-17	3.0
2s/10s weighted bull flattener	24-Feb-17	24-Mar-17	0.3
Reds/blues wtd curve steepener using midcurve	20-Jan-17	21-Apr-17	0.0
2s/10s weighted bear steepener	10-Feb-17	05-May-17	1.2
1s/5s weighted bear steepener	31-Mar-17	05-May-17	1.9
1Y/Jun17 Bobl bull falttener	03-Mar-17	26-May-17	-9.0
2s/10s weighted bear steepener	05-May-17	02-Jun-17	0.0
2s/5s/10s bear belly cheapener	10-Mar-17	02-Jun-17	0.0
Schatz/Bund weighted bear steepener	02-Jun-17	07-Jul-17	5.6
1s/10s weighted bull flattener	28-Apr-17	14-Jul-17	-4.2

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Trades closed over the past 12 months

TRADE	ENTRY	EXIT	P&L
CONDITIONAL CURVE AND FLIES (contd)			
Sep17 Schatz/Bund weighted bear steepener	07-Jul-17	18-Jul-17	0.0
3s/20s weighted bull flattener	14-Jul-17	15-Sep-17	-6.9
Schatz/Bund weighted bear steepener	01-Sep-17	15-Sep-17	2.0
SWAP SPREADS			
Dec16 Bund bear widener	09-Sep-16	23-Sep-16	1.0
Dec16 Bobl bull widener	16-Sep-16	30-Sep-16	2.1
Schatz/Bund OIS SS curve steepener	02-Sep-16	23-Nov-16	-9.0
Dec16 Bobl bear narrower	14-Oct-16	25-Nov-16	-3.0
Mar17 Bund OIS swap spread widener	23-Nov-16	06-Jan-17	7.2
Mar17 Schatz OIS swap spread widener	06-Jan-17	03-Feb-17	5.2
Apr17 Bund bull widener via call/receiver spreads	03-Feb-17	10-Feb-17	1.0
Mar17 Bund/Buxl OIS swap spread curve flattener	06-Jan-17	10-Feb-17	3.2
Reds/Greens FRA/OIS curve steepener	23-Nov-17	10-Feb-17	0.2
Mar17 Bobl/OIS swap spread	03-Feb-17	07-Feb-17	3.7
Jun17 Bund bull widner via call/receiver spreads	10-Feb-17	24-Feb-17	0.9
Receive 5Y in 2s/5s/10s xccy fly	15-Sep-16	24-Mar-15	0.0
Jun17 Bund bear widener	03-Mar-17	24-Mar-17	1.2
Bund/Buxl swap spread curve flattener	24-Feb-17	24-Mar-17	1.5
Pay Bund SS in Schatz/Bund/Buxl SS fly	24-Mar-17	07-Apr-17	0.6
Bobl/Bund swap spread curve steepener	07-Apr-17	21-Apr-17	1.2
Jun17 Schatz OTM bear widener	31-Mar-17	21-Apr-17	0.5
Sep17 FRA/OIS widener	10-Feb-17	28-Apr-17	-3.7
Jun17 Bund bear narrower	28-Apr-17	05-May-17	0.2
Bobl/Bund level adjusted flattener	05-May-17	12-May-17	2.0
Jul17 Bund bear narrower	05-May-17	12-May-17	0.0
Sep17 Schatz/OIS swap spread widener	12-May-17	02-Jun-17	5.0
Jul17 Bund bull widener	19-May-17	02-Jun-17	2.6
Jun17 Schatz/Bund OIS swap spread curve flattener	12-May-17	02-Jun-17	-2.9
Rec Bobl in level adj Schatz/Bobl/Bund SS fly	19-May-17	02-Jun-17	0.8
Reds/Greens FRA/OIS curve steepener	19-May-17	16-Jun-17	0.4
Jul17 Bund bear narrower	02-Jun-17	23-Jun-17	0.0
Sep17 Schatz/OIS swap spread widener	16-Jun-17	04-Aug-17	2.0
Sep17 Bund bull widener	09-Jun-17	11-Aug-17	0.2
Sep17 Schatz/Bund OIS swap spread curve flattener	09-Jun-17	18-Aug-17	0.0
Pay Bobl in Schatz/Bobl/Bund OIS SS fly	14-Jul-17	18-Aug-17	0.5
Sep17 Bund bear narrower	29-Jun-17	25-Aug-17	0.0
Dec17 Schatz/OIS swap spread widener	18-Aug-17	01-Sep-17	3.5
Dec17 Bund bull widener	14-Jul-17	01-Sep-17	0.3
Dec17 Bund/OIS swap spread narrower	08-Sep-17	22-Sep-17	1.3
TRADE	**ENTRY**	**EXIT**	**P&L**
OPTIONS (OUTRIGHT)			
Short Dec16 Schatz gamma	02-Sep-16	23-Sep-16	2.0
Sell Nov16 Bobl unhedged strangles	23-Sep-16	14-Oct-16	16.0
Buy Nov16 Bund put fly	16-Sep-16	14-Oct-16	9.0
Buy 3Mx(2Yx2Y) EUR gamma	23-Sep-16	28-Oct-16	8.0
Buy 1Yx1Yx10Y synthetic forward vol	30-Sep-16	28-Oct-16	2.0
Buy 3Mx30Y gamma via OTM payers	28-Oct-16	11-Nov-16	30.0
Sell Dec16 Schatz unhedged strangles	21-Oct-16	25-Nov-16	-4.0
Short 3Mx(2Yx2Y) midcurve gamma	28-Oct-16	09-Dec-16	-3.2
Sell 3Mx2Y gamma	23-Nov-16	06-Jan-17	4.5

TRADE	ENTRY	EXIT
OPTIONS (OUTRIGHT) (contd)		
Sell Mar17 Schatz unhedged strangles	06-Jan-17	03-Feb-17
1Yx15Y ATMF+50/100bp payer spread	04-Feb-16	03-Feb-17
Long OTM Apr17 Bund gamma	03-Feb-17	10-Feb-17
Buy Apr17 Bund calls vs 3Mx10Y GBP receivers	03-Feb-17	10-Feb-17
Long OTM Jun17 Bund gamma	10-Feb-17	24-Feb-17
Buy Jun17 Bund calls vs 3Mx10Y GBP receivers	10-Feb-17	24-Feb-17
Buy 3Mx10Y gamma	06-Jan-17	03-Mar-17
Long OTM Jun17 Bund gamma	24-Feb-17	17-Mar-17
Short 1Yx2Y EUR gamma	06-Jan-17	21-Apr-17
Buy Jun17 Schatz 1x2 put spread	07-Apr-17	28-Apr-17
Jun17 Bund OTM gamma via calls	24-Mar-17	28-Apr-17
Sell Jun17 Schatz gamma via puts	24-Feb-17	05-May-17
Buy 3Mx10Y gamma	07-Apr-17	05-May-17
Sell Jul17 Schatz gamma	05-May-17	19-May-17
Sell 3Mx(2s/10s) curve gamma	12-May-17	02-Jun-17
1Yx1Yx30Y EUR forward vol	09-Jun-17	07-Jul-17
Sell Aug17 Schatz unhedged strangle	19-May-17	07-Jul-17
1Yx2Yx20Y EUR forward vol	07-Jul-17	14-Jul-17
Sell 3Mx5Y gamma via OTM receivers	21-Jul-17	01-Sep-17
Buy Oct17 Bund call spread	11-Aug-17	08-Sep-17
Buy Dec17 OTM Bund put versus call	01-Sep-17	15-Sep-17
Buy 10Yx10Y vega	11-Aug-17	22-Sep-17
OPTIONS (RELATIVE)		
Sell Dec16 Schatz gamma versus swaptions	30-Sep-16	25-Nov-16
Short 10Yx2Y versus 10Yx10Y	04-Nov-16	09-Dec-16
2s/10s vol curve steepener	23-Nov-16	06-Jan-17
Schatz/Bund vol curve steepener	24-Mar-17	21-Apr-17
Sell 10Yx30Y vega vs 20Yx20Y	10-Feb-17	02-Jun-17
Schatz/Bund vol curve steepener	02-Jun-17	07-Jul-17
Long Sep17 bund gamma versus swaptions	09-Jun-17	07-Jul-17
Long Sep17 bund gamma versus swaptions	14-Jul-17	04-Aug-17
Buy 1Yx10Y versus 6Mx10Y equinotional	05-May-17	01-Sep-17
OPTIONS (MONEY MARKET)		
Sell 99.75 Mar17 SS unhedged straddles	05-Aug-16	21-Oct-16
Short Mar18 Euribor gamma	10-Feb-17	21-Apr-17
Buy Mar18 Euribor condor	03-Feb-17	02-Jun-17
MISCELLANEOUS		
3Mx(GBP - USD) bear widener	06-Oct-16	14-Oct-16
Buy 1Yx2Y USD gamma versus EUR	23-Nov-16	06-Jan-17
6Mx(1Yx1Y) USD - EUR bear widener	23-Nov-16	06-Jan-17
6Mx1Y (GBP - EUR) conditional wtd bull widener	02-Sep-16	03-Mar-17
Euro$/Euribor bear widener via Jun17 1Y MC put	24-Feb-17	03-Mar-17
Euribor/SS bull widener via Jun17 1Y MC call	10-Mar-17	24-Mar-17
Buy 2Y Schatz call versus UST	23-Jun-17	21-Jul-17
Buy Sep17 2Y UST put versus Schatz	21-Jul-17	25-Aug-17
6Mx5Y (USD-EUR) wtd bear widener	31-Mar-17	08-Sep-17
Buy Dec17 2Y UST put versus Schatz	18-Aug-17	15-Sep-17
Buy Dec17 2Y UST put versus Schatz	15-Sep-17	22-Sep-17
Buy Dec17 1Y Euro$ MC put versus Euribor	03-Mar-17	22-Sep-17

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- **The BoE has shifted its rhetoric in a non-linear way and seems intent on delivering a rate hike in the next few months despite an ambiguous domestic data backdrop**
- **In light of our revised BoE rate call we replace receiving Nov17 MPC OIS with a Nov17/Feb18 MPC OIS steepener**
- **Reds and greens SONIA rates are rich vs. our baseline Bank Rate forecast, however we stay neutral at the front end of the curve given ongoing Brexit transition uncertainty**
- **We review the trends around prior BoE Bank Rate hiking cycles and note 1Yx1M forwards historically have risen on average 70bp 3M into the first hike. However, given the recent sell-off and a more uncertain speed of any upcoming BoE tightening we see limited potential for a repeat of this dynamic**
- **May's Florence Brexit speech outlines 2Y transition with effective status quo, but offers little to break the current negotiation deadlock**
- **Stay neutral on 10Y gilt yields**
- **We expect seasonal demand dynamics to put further flattening pressure on the 10s/30s gilt curve, but the magnitude of any flattening is likely limited**
- **Keep 5Yx5Y/15Yx15Y GBP swap curve flattener**
- **Gilt RV: We recommend selling the belly of the 4T38/3Q44/1H47 cash and duration neutral fly**
- **We shift to a widening bias on 10Y swap spreads**
- **Keep 2s/10s bull steepeners using 3M receivers. Stay bullish on implieds in the 10Y sector, keep long 5Yx10Y vega**

Slow progress

Since the last *GFIMs*, UK rate markets have been calmer following the BoE rhetoric shift the prior week. 10Y gilt yields are 3bp higher with 1Y GBP swap rates modestly higher, outperforming the move in 1Y USD swaps (**Exhibit 1**). May's Brexit speech had little impact on UK rate markets, with little to suggest the deadlock in negotiations will be broken any time soon.

Exhibit 1: GBP rates are modestly higher on the week, outperforming USD a touch
Change in GBP, USD and EUR swap rates since 15 Sep 2017; bp

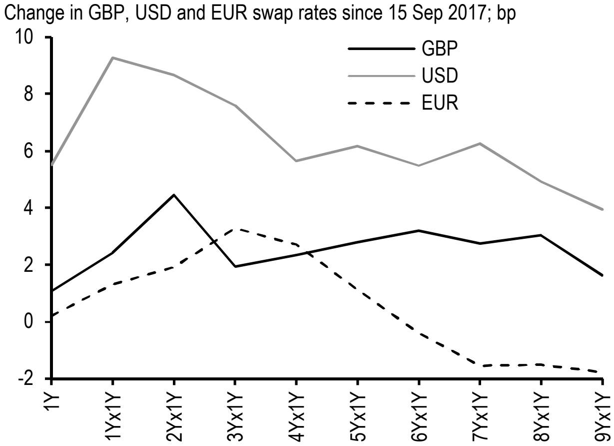
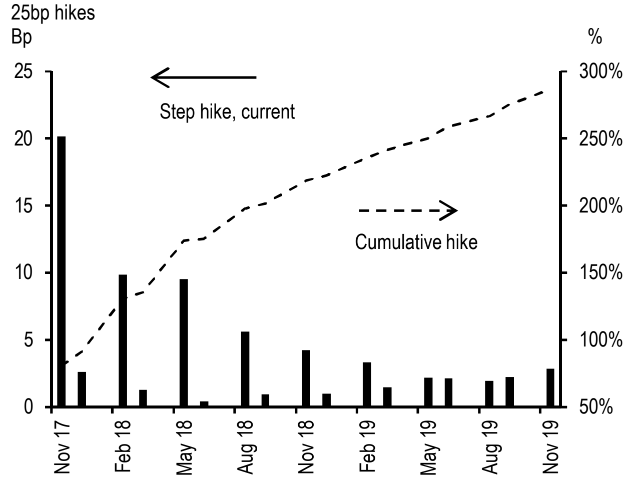


Exhibit 2: We shift receiving Nov17 MPC OIS into Nov17/Feb18 MPC OIS curve steepeners
Amount of hiking priced per meeting date and total cumulative probability of 25bp hikes



The start of this week saw a speech from Carney which built on both the message from the September MPC minutes and Vlieghe's speech, suggesting that the MPC is impatient to start a tightening cycle in the coming months. Carney's speech gave the impression that macro conditions for a rate hike have already been met, with recent global developments strengthening the case for higher UK rates now. Our economists have revised their BoE rate call and now expect a 25bp hike in November this year and 50bp of hikes in 2018 (May18 and Nov18).

The BoE has shifted its rhetoric in a non-linear way over the past week and seems fairly intent on delivering a rate hike in the coming months despite an ambiguous data backdrop. This past week has seen a more modest continuation of last week's substantial repricing, with reds and greens SONIA around 3-4bp higher. 80% chance of a 25bp hike is priced for Nov17 with just over

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Exhibit 3: A compendium of previous BoE rate hike cycles; we expect any further sell-off in front end rates into the first hike to be limited compared to historical averages

Previous BoE rate hikes cycles, level of 1Yx1M and 2Yx1M GBP swaps and 'perfect' 1M forward rate* at end of the hiking cycle, observed 3M prior to and at the start of the first hike; % unless stated

							3M prior to first hike (i)*					At first hike (ii)*					Change (ii - i); bp	
First hike	Last hike	Bank Rate Start	Bank Rate end (a)	Cumulative hikes; bp	Months	Pace /month, bp	1Yx1M	2Yx1M	1Yx1M/ 2Yx1M	Perfect fwd* (b)	Diff. (b -a); bp	1Yx1M	2Yx1M	1Yx1M/ 2Yx1M	Perfect fwd* (c)	Diff. (c -a); bp	1Yx1M	1Yx1M/ 2Yx1M
12-Sep-94	2-Feb-95	5.13	6.63	150	5	31	7.21	9.01	1.80	6.62	-1	8.01	9.29	1.28	6.58	-5	80	-52
30-Oct-96	4-Jun-98	5.69	7.50	181	19	9	6.54	7.64	1.10	7.62	12	7.02	7.43	0.40	7.29	-21	49	-70
8-Sep-99	10-Feb-00	5.00	6.00	100	5	19	5.69	6.27	0.58	5.59	-41	6.77	7.21	0.44	6.20	20	108	-14
6-Nov-03	5-Aug-04	3.50	4.75	125	9	14	4.14	4.54	0.40	4.13	-62	5.06	5.43	0.37	4.83	8	92	-4
3-Aug-06	5-Jul-07	4.50	5.75	125	11	11	5.07	5.24	0.17	5.13	-62	5.26	5.26	0.00	5.26	-49	19	-17
Average				136	10	17					-31					-9	70	-31

* We define the 'perfect' forward as the 1M forward rate at the time of the last hike in the cycle, as measured 3M before the start of hiking and at the start of the first hike. We use this as way to identify how accurate forwards are in terms of predicting the level of rates at the end of the cycle, assuming perfect foresight . This is an ex-ante measure

30bp of cumulative tightening priced for Feb18 and 55bp of cumulative tightening by the end of 2018. In terms of step pricing, the MPC OIS market prices decreasing steps after November (**Exhibit 2**), as markets struggle to identify the pace of potential BoE tightening following an initial 25bp first hike.

Given both our revised BoE call for a 25bp hike in November and the rhetoric from Carney we think it is now difficult for the BoE to back away from a hike this November. However, we think the Nov17/Feb18 MPC OIS curve can steepen, as in the event the BoE does hike 25bp in November we expect the Nov17/Feb18 MPC OIS curve to price more than the current additional11bp of hikes in February given the recent non-linear shift in BoE rhetoric. **We shift receiving Nov17 MPC OIS into a Nov17/Feb18 MPC OIS curve steepener**.

We think it is unlikely that the BoE will deliver a 'one 25bp-and-done'hiking cycle, given: *1*) the reversal of post-Brexit easing requires more than a single 25bp hike given the QE extension last August, and *2*) Carney argued that the upshift in global equilibrium rates is prompting the BoE to play catch up, a process that is unlikely to be complete in the near term. As a result, we think identifying the exact domestic data markers the MPC will be focusing on after the first hike will be difficult, but we think at a minimum domestic wages will need to rise towards the 3% level in 2018.

As turning points in central bank policy approach, investors and markets tend to look back to previous rate cycles for guidance. In **Exhibit 3**, **we provide a compendium of prior BoE Bank Rate hiking cycles** since 1994.

Exhibit 4: On average prior to the first hike 1Yx1M forwards have underestimated Bank Rate at the *end* of hiking cycle…

Spread between 1Yx1M GBP and Bank Rate at end of each hiking cycle, measured at: 3M prior to first rate hike in cycle; bp

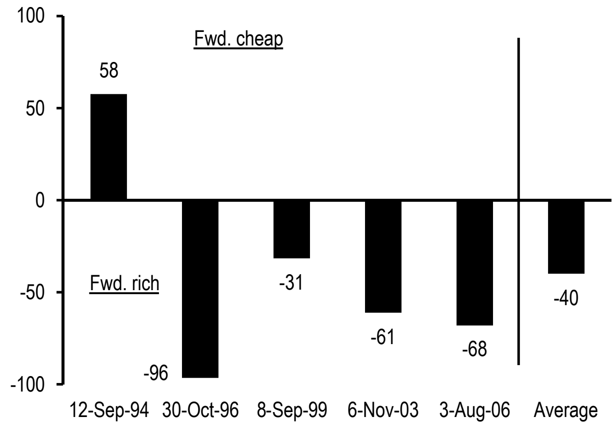
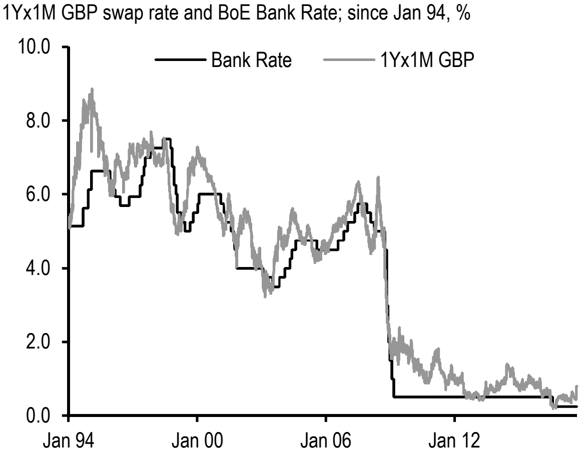


Exhibit 5: …although forwards tend to overshoot at the end of hiking cycles

1Yx1M GBP swap rate and BoE Bank Rate; since Jan 94, %



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We make the following observations: *1*) historically, rate hike cycles averaged 10 months from start to finish and averaged 130bp of hiking, with the longest cycle just over a year and a half in length, *2*) **from 3M prior to the first hike until the date of the first hike itself, 1Yx1M forwards increased on average 70bp** and the 1Yx1M/2Yx1M curve flattened, based on rolling forward dates. The fixed date forward rate curve may not flatten, and *3*) if we assume markets had perfect foresight and could predict the end point of the hiking cycle, then forwards at this end point as observed 3M prior to the first rate hike were on average 30bp lower than the terminal rate in the cycle.

The last observation is clearly somewhat artificial, but we also note that historically 3M prior to the start of the first hike that 1Yx1M GBP forwards are too low (on average 40bp) vs. the level of Bank Rate realized at the end of the cycle (**Exhibit 4**), although it depends on the length of the tightening cycle. This dynamic has typically reversed by the time of the first rate hike itself with 1Yx1M GBP forwards typically overshooting at the end of the hiking cycle (**Exhibit 5**).

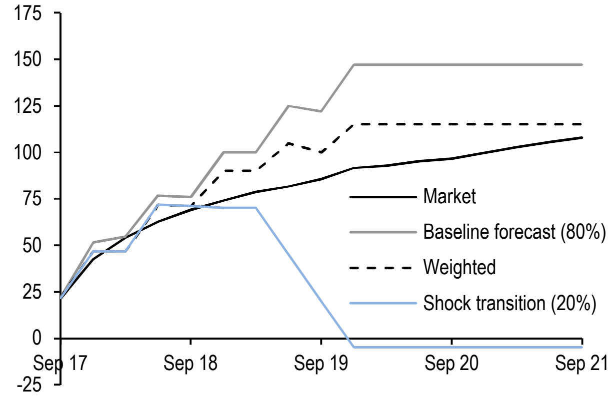
Given the BoE has stated that any upcoming hiking cycle will be slower and shallower than previous cycles, we think it is difficult to compare the average pace in previous cycles with current market pricing as currently 100bp of BoE hikes is not fully priced until around 5Y time. In addition, in light of the recent 20bp sell-off in 1Y and the 35-40bp sell-off in reds and greens since 5 September **we think it is unlikely front end rates will sell-off in line with the 70bp average move seen 3M prior to the first rate hike historically**.

Our baseline Bank Rate forecast suggests that front end yields can rise further into an expected November rate hike. We note that under our base Bank Rate forecast that reds and greens SONIA are rich by around 30bp and 50bp respectively (**Exhibit 6**). As we have already highlighted, market pricing reflects a weighted set of scenarios and we continue to think that risks of a Brexit transition shock need to be reflected in market pricing. Under our weighted scenario 1Yx1Y and 2Yx1Y SONIA both look around 20bp rich, **however we remain neutral on duration at the front end of the curve** as: *1*) we need to see more progress in UK/EU Brexit negotiations to drive a further leg of the sell-off and, *2*) we lack clarity around the speed of any rate rises following the first hike.

From an RV perspective, we note that the belly of the 1Yx1Y/2Yx1Y/3Yx1Y GBP swap fly (50:50) has underperformed and is now at its cheapest levels since April 2016. This fly is highly positively correlated with

Exhibit 6: Reds and greens SONIA rates are rich vs. our baseline Bank Rate forecast and, to a lesser degree, compared to a weighted scenario forecast; however we stay neutral at the front end of the curve given ongoing Brexit transition uncertainty

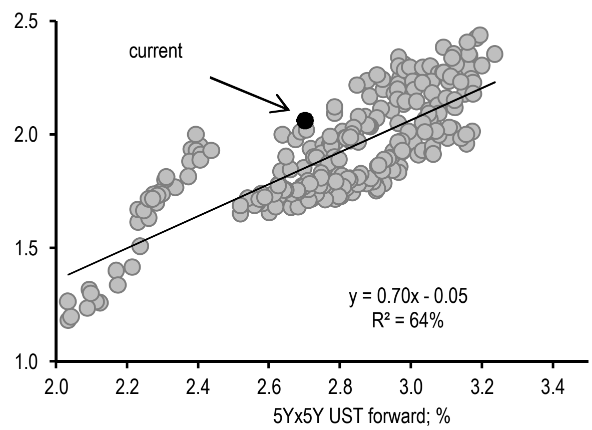
Market 1M SONIA rates at various forwards and expected SONIA* rate under various BoE Bank Rate scenarios**; bp



* We assume SONIA vs. Bank Rate spread of -4bp and term premia of 5bp
** Baseline BoE Bank Rate scenario: 25bp hike in 4Q17, 50bp of hikes in 2018 and 50bp of hikes in 2019 (80%). Shock transition: BoE hikes 25bp in 4Q17 and 50bp in 2018 and then cuts to 0bp in 4Q19 (20%)

Exhibit 7: 5Yx5Y par gilt yields remain correlated with 5Yx5Y UST yields despite the recent BoE-driven repricing

5Yx5Y par gilt forward regressed against 5Yx5Y UST forward, past 12M; bp



2Yx1Y rates but is trading around 1.4bp cheap on a 6M regression basis. **For investors looking to fade the sell-off, receiving the belly of the 1Yx1Y/2Yx1Y/3Yx1Y GBP swap fly (50:50) offers some modest attractive RV** (1.5bp).

Theresa May's much awaited Brexit speech was ultimately underwhelming in the details. There was much talk of achieving an ambitious and creative new future agreement with the EU and we know that the UK is not aiming for either EEA membership or a Canadian-style deal post the transition period. However, there is little detail on how the new arrangement would operate and there is no recognition from May on the fact that post-transition, the UK will become a 'third country' from the perspective of the EU.

May also outlined that the UK will look for a time-limited transition deal for around two years from March 2019, under which the UK will effectively remain bound by the EU acquis. There was acknowledgement that the UK will contribute to the EU budget up to 2020 and honour budget commitments but no exact details on the amounts involved.

The next round of UK/EC Brexit negotiations kicks-off next week alongside the start of the party conference season (Labour party conference starts on 24 September), and we see little from May's speech to suggest that the deadlock will quickly be broken.

We remain neutral on 10Y duration. Over the medium term we expect 10Y yields to rise due to higher global rates, but from a more short term perspective our momentum model is continuing to show a bullish signal. We note that despite the BoE driven repricing that 5Yx5Y par gilt yields have exhibited decent positive correlation with 5Yx5Y UST yields and look modestly cheap on a regression basis (**Exhibit 7**)

The 2s/5s par gilt curve is a touch steeper on the week but as we highlighted in the last *GFIM*s, GBP money market curves and the 2s/5s curve have generally been sticky in the recent sell-off, as markets are unable to price in a significant amount of term premia due to BoE rhetoric of a slow and steady hiking cycle. The 2s/5s par gilt curve and 2s/5s swap curve both exhibit strong positive correlation with the reds/greens GBP curve and both look fair value from a regression standpoint.

Further out, the 10s/30s gilt curve has flattened further on the week with the 10s/30s par gilt curve close to its flattest levels since August 2015. **We expect seasonal demand dynamics to put further flattening pressure on the 10s/30s gilt curve**, but we think that the magnitude of any further flattening is relatively limited in nature. On a long run regression basis the 10s/30s par gilt curve is already relatively flat given the level of 10Y gilt yields (**Exhibit 8**) and we think 10Y yields would need to be substantially higher for the 10s/30s par gilt curve to flatten through the 50bp level (56bp currently). **We continue to express our 10s/30s flattening view via 5Yx5Y/15Yx15Y GBP swap curve flatteners.**

Exhibit 8: We hold a tactical flattening view on 10s/30s but the potential for further flattening is limited given the long run directionality with 10Y yields

10s/30s par gilt curve regressed against 10Y par gilt yield; past 10Y; bp

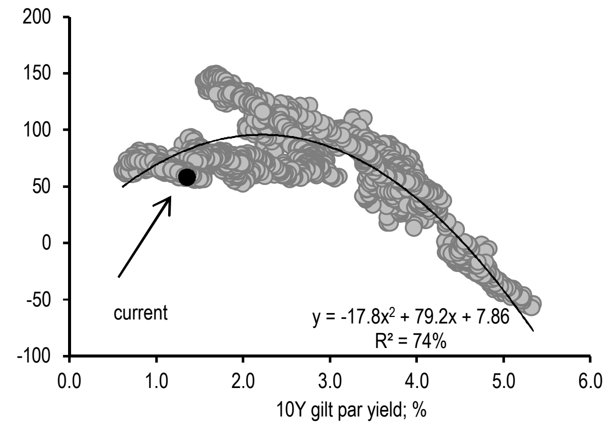
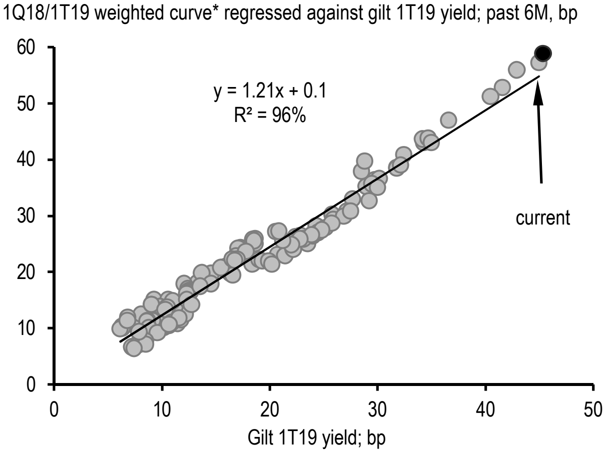


Exhibit 9: Buying 1T19 vs. selling 1Q18 cash-for-cash looks attractive as an RV-efficient way to fade the recent sell-off

1Q18/1T19 weighted curve* regressed against gilt 1T19 yield; past 6M, bp



* Risk weights: -100%/219%

Exhibit 10: The recent sell-off has created micro dislocations on the gilt curve

Z-score of richness* vs. our par curve model, and Z-score of adjacent fly centered on each gilt**, past 3M

Gilt	Z-score gilt richness*	Z-score adj. fly lev el**
3T19	-2.3	-2.3
4Q32	-2.3	-2.2
4Q39	-1.3	-2.2
3Q44	-2.8	-2.5
3T52	-2.4	-2.2
2H65	-1.1	-2.0

* Richness = actual yield - model yield calculated on J.P.Morgan par curve model

** Adjacent gilt fly (50:50) for which named gilt is in the belly

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Gilt RV

At the short end we note the implied forward yield between gilt 1Q18 and 1T19 is trading at its cheapest levels since June 2016. The recent cheapening of this implied forward yield is a function of the BoE-driven sell-off but the weighted curve (219% in 1T19 and -100% in 1Q18) currently looks 3bp too steep vs. the level of 1T19 yield based on a 6M regression (**Exhibit 9**). For investors who own sub 1Y gilts and want to fade the recent sell-off while picking up RV, buying 1T19 vs. selling 1Q18 cash-for-cash looks attractive.

In addition, we note that this week saw the last of the reinvestment operations of the cash proceeds from gilts 8T17 and 1s17. With no QE reinvestment operations until gilt 5s18 matures in March if any, we see room for the 1H26/4Q27 to flatten further, and **keep 1H26/4Q27 gilt curve flatteners**, targeting the 6bp level.

The recent sell-off in gilt yields has created some dislocations on the curve, with several gilts looking rich both relative to our par curve model and on flies vs. surrounding gilts (**Exhibit 10**). Absent another large repricing in gilt markets, we would expect the relative richness of those bonds to correct.

In particular, **we recommend selling the belly of the 4T38/3Q44/1H47 cash-and-duration neutral fly** (risk weights: 44%/-100%/56%), which currently trades 1.5bp below its 12M average (**Exhibit 11**) and has generally exhibited limited directionality with the level of yields or curve.

In addition, **we stay short the belly of the 5s25/4Q32/4T38 gilt fly** (50:050) as a view on the richness of this fly historically as well as the richness of 4Q32 on our par curve.

Swap spreads – 10Y widening bias

Gilt swap spreads have seen a mixed performance over the week with 2Y swap spreads widening, 5Y swap spreads unchanged and 10Y and 30Y swap spreads narrower (**Exhibit 12**).

Following the recent narrowing, 10Y swap spreads are now back at their narrowest levels since late February. In fact, 10Y swap spreads have been fairly well range-bound for the past 6 months with the recent narrowing a function of the back-up in yields. 10Y swap spreads now look marginally too narrow vs. the level of yields (**Exhibit 13**), and given our neutral duration stance **we have a mild widening bias on 10Y swap spreads**.

Exhibit 11: We recommend selling the belly of the 4T38/3Q44/1H47 cash-and-duration neutral fly

4T38/3Q44/1H47 cash and duration neutral fly (risk weights: 44%/-100%/56%); past 12M, bp

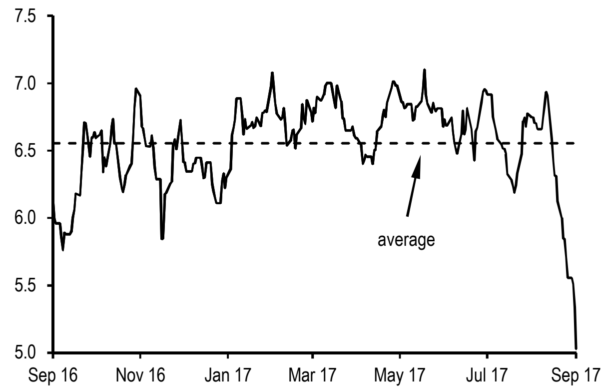


Exhibit 12: GBP swap spreads have seen mixed performance across the curve over the week

Change in benchmark gilt swap spread since 8 Sep; bp

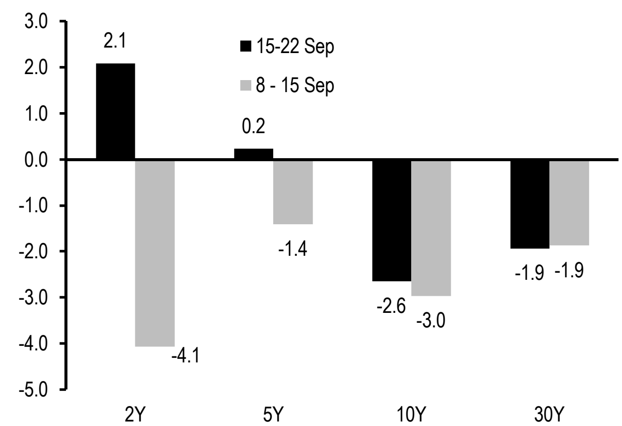
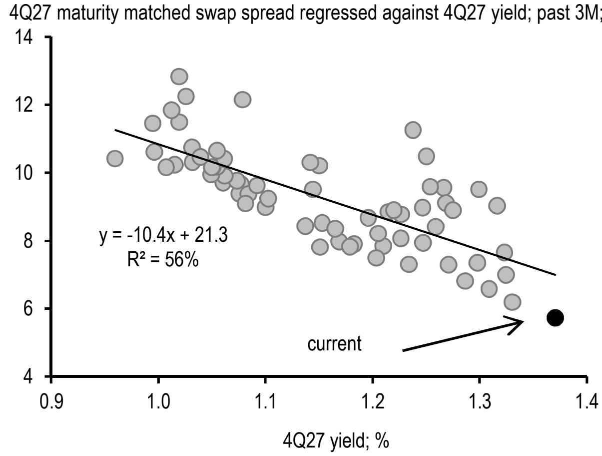


Exhibit 13: 10Y swap spreads trade modestly too narrow vs. the level of 10Y yields; we have a widening bias on 10Y swap spreads

4Q27 maturity matched swap spread regressed against 4Q27 yield; past 3M; bp



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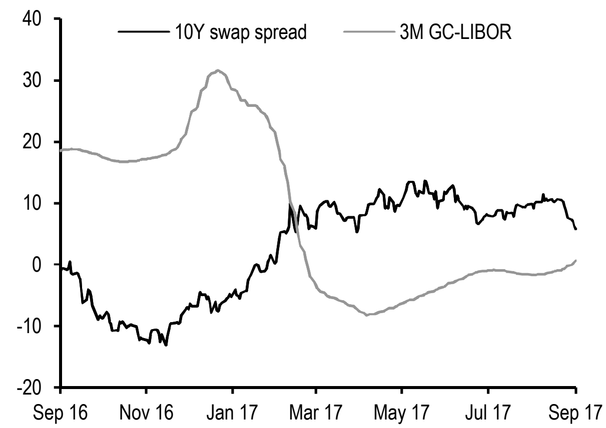
Over the longer-run, we note that balance sheet and funding costs as measured by GC-LIBOR spreads can explain the broad dynamics of 10Y swap spreads (**Exhibit 14**). Some of the recent narrowing reflects a cheapening in GC-LIBOR, but for 10Y swap spreads to trade much narrower than current levels on pure funding dynamics, we think GC-LIBOR would need to cheapen materially back to the levels seen in late 2016/early 2017.

Exhibit 14: GC-LIBOR spreads would need to considerably cheapen to put further narrowing pressure on 10Y swap spreads
10Y par gilt swap spread and 3M GC-LIBOR spread; bp



Trade recommendations[19]

High-conviction trades are starred (★). All other recommendations are moderate-conviction

- **Close long Nov17 MPC OIS…**
– Close long £100mn in Nov17 MPC OIS @ 41.0bp. P&L since inception is -0.7bp (recommended 15 September)

- **…and enter Nov17/Feb18 MPC OIS steepeners**
– Go short £100mn in Feb18 MPC OIS vs. long £100mn in Nov17 MPC OIS @ 11.5bp.

- **Go short the belly of the 4T38/3Q44/1H47 cash and duration neutral fly (44%/-100%/56%)**
– Go short £50mn of gilt 3Q44 vs. buying £23mn of gilt 4T38 and £31mn of gilt 1H47 (all notional sizes) @ 4.9bp. 3M carry and slide is 0bp. Click here to see this trade in our *Trade Analyzer*.

- **Stay short the belly of the 5s25/4Q32/4T38 gilt fly (50:50)**
– Stay short £50mn of gilt 4Q32 vs. buying £47mn of gilt 5s25 and £17mn of gilt 4T38 (all notional sizes) @ 20.9bp. 3M carry and slide is 0bp. Click here to see this trade in our *Trade Analyzer*. P&L since inception is +1bp (recommended 15 September)

- **Keep 2s/10s GBP/USD cross-currency basis curve steepeners**
– Current level: 3.2bp. P&L since inception is -0.7bp (recommended 30 August in *Cross currency basis 4Q17 Outlook*).

- **Keep 1H26/4Q27 gilt curve flatteners**
– Stay long £100mn of gilt 4Q27 vs. short £130mn (all notional sizes) of gilt 1H26 @ 10.3bp. 3M carry and slide is +0.3bp. Click here to see this trade in our *Trade Analyzer*. P/L since inception is +0.2bp (recommended 11 Aug).

- **Keep 3Mx1Y FRA/OIS wideners**
– Pay £100mn 3Mx1Y GBP LIBOR vs. long £100mn 3Mx1Y SONIA @ 6.1bp. 3M carry and slide is -1.5bp. P&L since inception is -2.4bp (recommended 21 July)

- **Keep 5Yx5Y/15Yx15Y swap curve flatteners (★)**
– Keep paying £100mn in 5Yx5Y swaps vs. receiving £42mn in15Yx15Y swaps @ -0.7bp. 3M slide is -3.6bp. P&L since inception is +8.0bp (recommended 13 September in *The UK long end view*).

- **Keep 30s/50s swap spread curve flatteners**
– Stay long £50mn (notional size) of gilt 1H47 vs. £45mn maturity-matched swaps @ -27.6bp, and short £28mn (notional size) of gilt 2H65 vs. £31mn maturity-matched swaps @ -20.6bp, a relative spread of +7.0bp. 3M carry and slide is -0.4bp. P&L since inception is -4.7bp (recommended 11 May in *The UK long end view*).

- **Keep 10Y GBP/USD cross-currency wideners**
– Receive £75mn of 10Y GBP/USD cross currency basis @ -7.0bp. 3M carry and slide is -0.3bp. P&L since inception is -4.4bp (recommended 15 September).

- **Keep 2s/10s bull steepeners using 3M receivers**
– Buy £470mn 0.84% 3Mx2Y receiver (notification date 15 Dec 2017, maturity date 15 Dec 2019) versus selling £100mn 1.327% 3Mx10Y receiver (notification date 15 Dec 2017, maturity date 15 Dec 2027) to remain in a premium neutral 2s/10s bull steepener at 48.7bp versus forward curve at 54.8bp

19 All trades priced as at 22 September 1pm except 1) Cross-currency basis trades 2) FRA/OIS wideners and 3) all existing volatility trades, priced as at 21 September close

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and spot 2s/10s curve at 60bp. P&L since inception is -3.6bp of notional (recommended 15 Sep)

- **Stay long 3Mx2Y OTM delta-hedged payers versus selling OTM receivers**
  – Buy £100mn 0.696% 3Mx2Y payers versus selling £100mn 0.496% 3Mx2Y receivers (ATMF strike 0.596%, notification date 1 Dec 2017, maturity date 1 Dec 2019) at an implied vol spread of 0.5bp/day. This trade requires daily delta-hedging; P&L since inception is +4.8bp of notional (recommended 1 Sep)
- **Stay long 5Yx10Y vega**
  – Buy £100mn 1.77% 5Yx10Y straddles (notification date 4 Aug 2022, maturity date 4 Aug 2032) at 4.55bp/day. This trade requires active delta hedging. P&L since inception is +3.2bp of notional (recommended 4 Aug)
- **Hold 15Yx20Y ATMF/ATMF+50 payer spread**
  Hold £100mn ATMF/ATMF+50 15Yx20Y payer spread (ATMF strike 1.48%, notification date 11 May 2032, maturity date 11 May 2052) at 314.1bp of notional versus initial level of 305bp of notional; P&L since inception is +9.1bp of notional (recommended 11 May in *The UK long end view*)
- **Hold 5s/10s bull steepener using 3M OTM receivers**
  – Buy £100mn 0.819% 3Mx5Y receivers (ATMF strike 1.019, notification date 16 OCT 2017, maturity date 16 Oct 2022) versus selling £52.2mn 1.158% 3Mx10Y receivers (ATMF strike 1.388, notification date 16 Oct 2017, maturity date 16 Oct 2027) to remain in a premium neutral 5s/10s bull steepener at 33.9bp versus forward level of 30.6bp and spot spread of 31bp ; P&L since inception is -0.3bp of notional (recommended 14 July)

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Trades closed over the past 12 months

TRADE	ENTRY	EXIT	P&L
DURATION			
Long Nov16 MPC OIS	19-Aug-16	30-Sep-16	-5
Short 30Y gilts	30-Sep-16	21-Oct-16	31
Long 1Yx1Y SONIA	23-Nov-16	04-Jan-17	4
Pay 15Yx15Y GBP vs. USD swaps	09-Dec-16	24-Feb-17	-10
Pay 10Yx10Y GBP vs. EUR swaps	10-Jan-17	24-Mar-17	-6
Short 10Y gilts	06-Jan-17	31-Mar-17	-30
Short 30Yx10Y forward gilt yield	05-May-17	26-May-17	-15
Long 3Mx1Y SONIA	12-May-17	26-May-17	0
Long 1Yx1Y SONIA	26-May-17	29-Jun-17	-21
Long 3Mx1Y SONIA	21-Jul-17	04-Aug-17	2
Long Nov17 MPC OIS	14-Jul-17	11-Aug-17	8
Short 10Y gilts	01-Sep-17	15-Sep-17	24
Pay 5Yx5Y GBP swaps vs. receiving EUR	19-May-17	15-Sep-17	7
Long Nov17 MPC OIS	15-Sep-17	22-Sep-17	-1
CURVE			
10s/30s gilt curve steepener	09-Sep-16	23-Sep-16	6
30s/50s gilt curve flatteners	23-Sep-16	14-Oct-16	3
10s/30s gilt curve steepeners	30-Sep-16	14-Oct-16	-6
30s/50s gilt curve flatteners	21-Oct-16	28-Oct-16	-2
Feb17/Aug17 MPC OIS curve flattener	28-Oct-16	04-Nov-16	2
Weighted reds/greens SONIA curve flatteners	04-Nov-16	11-Nov-16	-5
2s/5s gilt curve steepeners	28-Oct-16	06-Jan-17	7
Weighted reds/greens SONIA curve steepeners	27-Jan-17	03-Feb-17	5
May17/Nov17 MPC OIS curve flatteners	20-Jan-17	03-Feb-17	3
10s/30s gilt curve steepeners	05-Dec-16	03-Feb-17	4
Short Sterling steepeners boxed w/ Euro flatteners	05-Mar-17	31-Mar-17	3
Sell belly 2s5s10s gilt fly	24-Mar-17	21-Apr-17	0
1Yx1Y/15Y GBP swap curve steepeners	23-Nov-16	21-Apr-17	-13
Reds/greens SONIA curve steepeners	03-Feb-17	12-May-17	-7
Sep17/Jun18 Short Sterling curve steepeners	28-Apr-17	12-May-17	2
10s/30s gilt curve flatteners	11-May-17	09-Jun-17	-4
1Yx1Y/2Yx1Y SONIA curve steepeners	16-Jun-17	23-Jun-17	-8
Nov17/May18 MPC OIS steepener	23-Jun-17	07-Jul-17	6
Pay belly 5s/10s/30s swap fly (50:50)	23-Jun-17	21-Jul-17	2
5s/10s gilt curve steepener	23-Jun-17	18-Aug-17	7
Dec18/Dec19 Short Sterling steepeners boxed with Euribor flatteners	11-Aug-17	01-Sep-17	5
30s/50s gilt curve flatteners	11-Aug-17	08-Sep-17	2
5s/30s gilt curve steepeners	09-Jun-17	13-Sep-17	0
5s/10s swap curve steepeners	01-Sep-17	15-Sep-17	-3
Reds/greens SONIA curve steepeners	08-Sep-17	15-Sep-17	5
SWAP SPREADS			
1Yx1Y FRA/OIS wideners	30-Sep-16	14-Oct-16	5
2Y swap spread narrowe	04-Nov-16	11-Nov-16	3
10s/30s swap spread curve flatteners	23-Nov-16	10-Feb-17	1
5Y swap spread narrower	12-May-17	16-Jun-17	3
30Y swap spread narrower	03-Feb-17	23-Jun-17	-7
2Y swap spread widener	18-Aug-17	01-Sep-17	3
30Y swap spread narrower	08-Sep-17	15-Sep-17	3

RELATIVE VALUE			
Receive belly of the 1Yx1Y/2Yx1Y/3Yx1Y level	15-Jul-16	05-Aug-19	0
Sell belly of the 1H21/1T22/4Q27 gilt fly (50:50)	09-Sep-16	23-Sep-16	4
Long belly 1Q18/3T19/1H21 gilt fly (50:50)	30-Sep-16	14-Oct-16	3
Sell belly 4H42/3Q44/4Q49 cash and duration neu	02-Sep-16	21-Oct-16	1
Sell belly 4Q49/3T52/4Q55 cash and duration neu	09-Sep-16	21-Oct-16	1
Sell belly 3T19/3T20/4s22 gilt fly	23-Sep-16	21-Oct-16	2
Receive belly lvl adjusted 1Yx1Yx1Y/2Yx1Y sw	04-Apr-16	21-Oct-16	-4
Sell belly 4H19/4T20/1T22 gilt fly (50:50)	28-Oct-16	11-Nov-16	-3
Lomg belly 4T20/4s22/2T24 gilt fly (50:50)	06-Jan-17	20-Jan-17	3
Long the belly of the 1Q18/3T19/3T20 gilt fly (50:	10-Feb-17	24-Feb-17	2
Short belly 2s/5s/10s gilt fly (50:50)	27-Jan-17	24-Feb-17	-4
Sell belly 2Q23/2T24/1H26 gilt fly (50:50)	20-Jan-17	10-Mar-17	1
Long 10s20s30s gilt fly (50:50)	24-Feb-17	10-Mar-17	0
Short 1T19/2T24/4T30 cash neutral gilt fly	10-Feb-17	24-Mar-17	1
Long 1Q18/3T19/1H21	31-Mar-17	07-Apr-17	2
Receive belly of the 3Mx1Y/1Yx1Y/2Yx1Y swap	31-Mar-17	28-Apr-17	1
Short the belly of the 1T19/3T20/1T22 gilt fly	03-Feb-17	05-May-17	-1
Long 10s30s50s gilt fly (50:50)	31-Mar-17	09-Jun-17	-3
4Q32/4H34 gilt curve flatteners	19-May-17	07-Jul-17	0
Short belly 2Q23/2s25/4Q27 (50:50)	02-Jun-17	04-Aug-17	-2
Long belly 2Q23/2S25/4Q27 (50:50)	09-Jun-17	04-Aug-17	1
Long belly 4Q27/4T30/4Q36 cash neutral fly	14-Jul-17	01-Sep-17	1
Short belly 4Q32/4T38/1H47 (50:50)	07-Jul-17	01-Sep-17	1
CONDITIONAL CURVE AND FLIES			
2s/10s GBP weighted bull flattener	19-Aug-16	14-Oct-16	0
2s/10s GBP weighted bear steepener	05-Aug-16	14-Oct-16	-9
2s/30s GBP weighted bear steepener	21-Oct-16	11-Nov-16	4
2s/30s weighted bear steepener	11-Nov-16	06-Jan-17	2
2s/30s weighted bull flattener	11-Nov-16	13-Feb-17	-5
1s/5s weighted bull flattener	03-Feb-17	24-Feb-17	2
6Mx10Y (GBP - USD) bear widener	06-Feb-17	03-Mar-17	-15
Fronts/Greens wtd bear steepener	03-Mar-17	02-Jun-17	1
5s/10s/30s bear belly cheapeners	31-Mar-17	16-Jun-17	0
Buy Mar19 SS 1Y MC calls versus Euribor	16-Jun-17	14-Jul-17	1
5s/10s/30s bear belly cheapeners	16-Jun-17	14-Jul-17	1
1s/5s weighted bull flattener	05-May-17	04-Aug-17	-5
2s/10s weighted bear steepener	01-Sep-17	15-Sep-17	-11
6Mx(5Yx5Y) (GBP-EUR) weighted bear widener	04-Aug-17	15-Sep-17	3
OPTIONS			
Buy 3Mx2Y GBP OTM unhedged strangles	17-Jun-16	24-Jun-17	5
Sell 3Mx2Y GBP gamma	04-Aug-16	21-Oct-16	8
Sell 3Mx2Y gamma	21-Oct-16	06-Jan-17	3
Buy 3Mx10Y gamma	06-Jan-17	03-Mar-17	-60
Sell 3Mx1Y gamma	06-Jan-17	31-Mar-17	3
Sell Sep17 unhedged SS straddles	10-Feb-17	05-May-17	3
Buy 3Mx10Y gamma	05-May-17	02-Jun-17	-50
Buy Jun17 2Y midcurve 1x2 put spread	05-May-17	02-Jun-17	-5
Buy 1Yx10Y versus 6Mx10Y	02-Jun-17	14-Jul-17	-7
Sell 5Yx5Y vega versus 5Yx10Y	03-Feb-17	14-Jul-17	-40
Buy 1Yx10Y versus 6Mx10Y	14-Jul-17	04-Aug-17	2
Buy 2Yx2Yx10Y forward vol	09-Jun-17	04-Aug-17	10
Buy 2Y Dec17 SS midcurve put fly	04-Aug-17	15-Sep-17	4

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Scandinavia

- **The yield curve bear steepened with a small underperformance of Stibor yield at the front end versus that of Nibor at the long end**
- **Macro data in Sweden keeps surprising on the upside; August inflation printed 0.1% higher versus Riksbank's forecast. Inflation expectations are now at or above target across all horizons**
- **Nevertheless, the Riksbank remains cautious on the strength of the currency and is happy to see inflation overshoot its target for a long period of time before shifting its rhetoric**
- **In line with the Riksbank, we expect the first 10bp hike to come in July 2018. However, risks are biased towards an earlier start and a faster pace; globally higher yields are likely to pressure Swedish yields higher despite Riksbank's dovishness**
- **We stay short duration via 5Y SEK real yield. On the curve, we take small profit on the 2s/10s curve steepener and instead recommend 1s/5s swap curve steepener**
- **We recommend 10Y Sweden swap spread narrowers as a medium term trade**
- **On a cross market basis, we hold shorts in Mar18 SEK FRA versus Short Sterling on the dichotomy in macro backdrop in the underlying economies and central bank reaction functions**
- **The Norges bank delivered a modestly hawkish surprise at its meeting by bringing its first hike forecast to 3Q19 (previously 4Q19) and steepening the repo rate trajectory**
- **We turn bearish on Norwegian duration and recommend fronts/greens Nibor curve steepeners**

Globally higher yields to push Swedish yields higher despite Riksbank's dovishness

Yields increased sharply over the past two weeks across the globe with a strong bear steepening of the yield curve. This was driven by multiple factors: upward surprises in the UK and US CPI inflation print followed by hawkish rhetoric at the MPC meeting and from individual members, a reduction of geopolitical risks, and the modestly hawkish outcome of the FOMC meeting. Nibor and Stibor yields moved broadly in parallel with a modest underperformance of Stibor at the very front-end as markets started to price an earlier hike by the Riksbank (**Exhibit 1**).

Exhibit 1: Yield curve bear steepened with a small underperformance of Stibor yield at the front end versus that of Nibor at the long end

Change in 1Y forward swap rates from 8 September 2017, bp

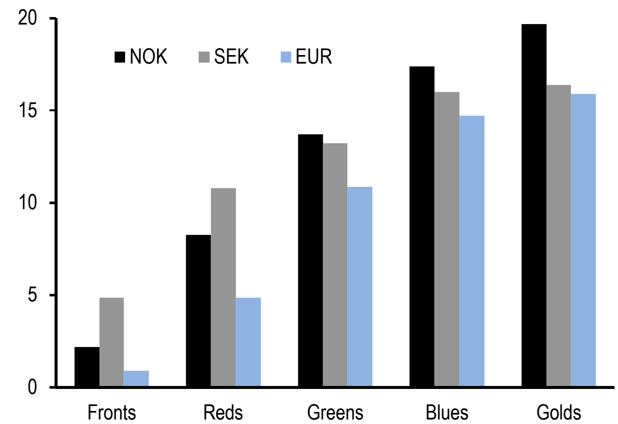
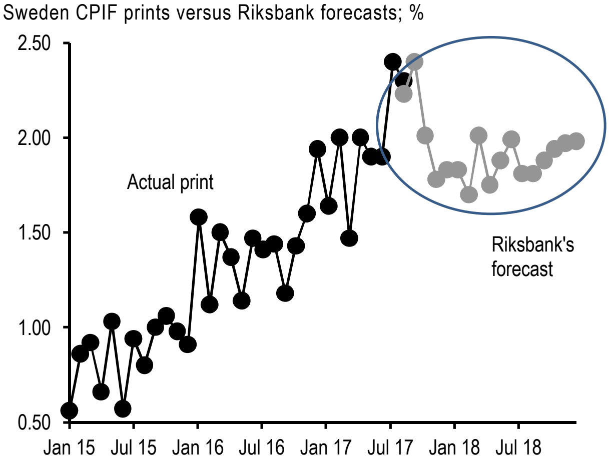


Exhibit 2: August inflation printed 0.1% above Riksbank's forecast. We expect the upward trend in inflation to remain intact

Sweden CPIF prints versus Riksbank forecasts; %



Source: Riksbank; J.P.Morgan.

Sweden

Inflation, GDP, and inflation expectations were the most important data markers since our last publication. Even though CPI and CPIF both declined 0.1% in August, they are currently at 2.1% and 2.3% oya, respectively. These are marginally above the Riksbank's forecast which was itself upgraded at the September meeting (**Exhibit 2**).

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Inflation has now surprised the central bank's forecast repeatedly this year and, in our view, this increase appears genuine and broad based. The final GDP release shows that 2Q17 GDP grew "*only*" 5.2% q/q ar versus the first estimate of 7.1%. We do not think that this downward revision will have a significant impact on Riksbank's estimate of output gap estimate which the central bank had revised upward from 0.7% to 1.6%. Indeed, the Riksbank may have to revise up the growth and output gap forecasts again to account for easier fiscal policy (the budget bill published this week intends 0.2-ppt of stimulus in 2018 compared to the original intention for a 0.3-ppt tightening).

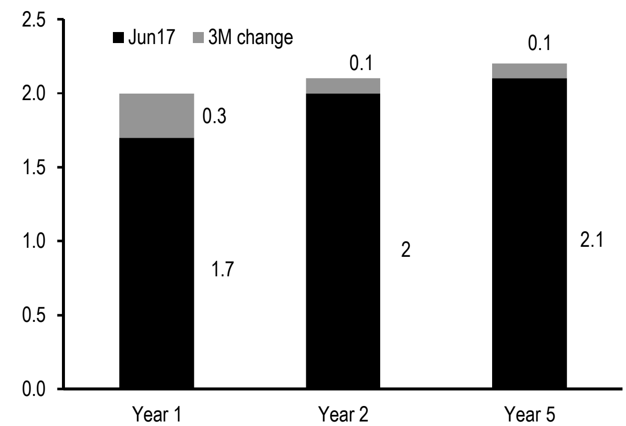
In a recent note, our economist had discussed that the Swedish monetary stance has been a long way from the typical Taylor rule for sometime: assuming a real equilibrium interest rate (r*) of 1.5% and a natural rate of unemployment of 7%, the appropriate policy rate at the moment is around 4.6% versus actual policy rate of -0.5%. Accounting for asset purchases would widen this differential even wider.[20] We had interpreted this divergence as Riksbank's concern about an erosion of inflation expectations. However, the latest Prospera survey shows that inflation expectations are now anchored at the target across all horizons; the quarterly all interviewee's expectations of 1-, 2-, and 5-year ahead inflation jumped higher to 2%, 2.1%, and 2.2%, respectively (**Exhibit 3**).

However, none of these appear to have any impact on the Riksbank's reaction function which remains steadfastly focused on the currency. The September meeting minutes reflected this again. Most of the members downplayed the rise in CPIF on the basis that the inflation numbers were partly distorted and remain concerned about the currency appreciation (the KIXI effective exchange rate has appreciated about 4% since the beginning of the year). We believe that it will take a few more positive surprises in inflation for the Riksbank to feel comfortable on its outlook.

The ECB and its policy reaction is also a key driver of the Riksbank reaction function. Unfortunately, the next Riksbank meeting is on October 25, a day before the ECB's next meeting. Given that market expects the ECB outline details about its tapering policy, we believe that the Riksbank will potentially wait until the December meeting to make significant changes to its policy path. At this point the Riksbank has signaled the first 10bp hike in July 2018, which is in line with our view. But we

Exhibit 3: Inflation expectations across all horizons are now at target

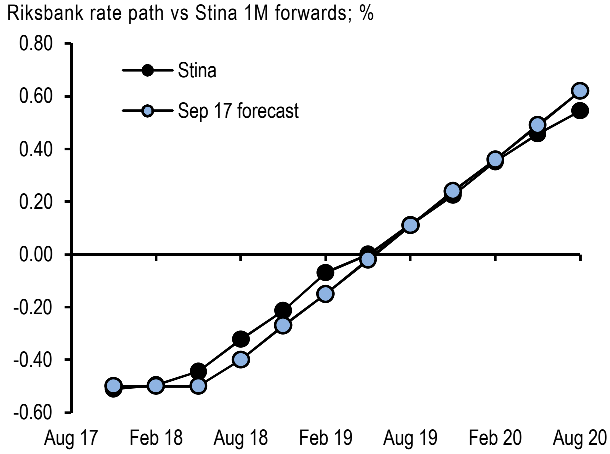
All interviewee's expectation of 1-, 2-, and 5-year ahead inflation expectations in June and 3M change; %



Source: TNS Sifo Prospera.

Exhibit 4: The Stina curve is priced broadly in line with the Riksbank. We see scope of earlier hike in policy rate and also see a steeper curve

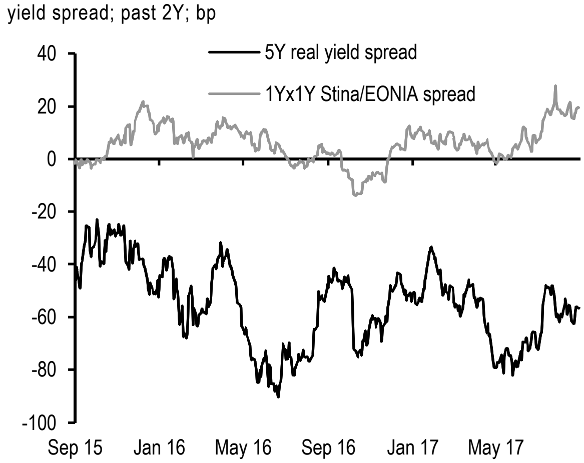
Riksbank rate path vs Stina 1M forwards; %



Source: Riksbank; J.P.Morgan.

Exhibit 5: Stay short 5Y SGB real yield

5Y (SEK - Germany) real yield spread and 1Yx1Y OIS (Stina - EONIA) yield spread; past 2Y; bp



[20] See *Riksbank: Stronger pressure, little response* by Raphael Brun-Aguerre, 1 Sep 2017.

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think that the risk is towards an earlier rise in rate and a steeper money market curve (**Exhibit 4**).

In addition to domestic pressure, we believe that global macro backdrop is also supportive of higher yields. The sharp repricing of the UK interest rate curve, the Fed still pointing towards another hike in 2017 and three more in 2018 versus a total of 40bp by end 2018 priced in the USD OIS curve, and uptick in global growth, etc all imply that globally yields are biased higher and the Swedish curve is not expected to remain behind.

In fact, given the solid domestic backdrop, **we expect Swedish yields to underperform their major global counterparts**. **We remain short duration in Sweden via short in 5Y real yields**. 5Y real yields are still around -2% despite solid macro and supportive fundamentals for higher yields. For instance, 5Y Swedish real yield is trading around 60bp below German real yield even though 1Yx1Y Stina rates are above EONIA (**Exhibit 5**). We also favour shorts in nominals, especially in the 2-5Y sector, given that risks towards Riksbank policy is towards an earlier hike versus later. 5Y real yield have recouped the decline seen in the second half of August and is currently around 2bp below inception levels.

The risk of an earlier and/or faster tightening cycle also brings with it the possibility of a bear-flattening of the 2s/10s curve as it could lead to an underperformance of reds/greens sector relative to longer end of the curve. Therefore, **we take small profit in our 2s/10s Stibor curve steepener** trade that we had recommended few weeks ago (P&L of around 3bp). Instead, **we recommend 1s/5s swap curve steepener** (see *Trade Recommendations*). This reflects our view that any repricing of the first hike will warrant a higher term premium. If the surge in inflation is sustained, the output gap remains at elevated levels, and the ECB starts to actively talk about exiting extraordinary measures including rate hikes, the Riksbank may be forced to steepen its rate trajectory rapidly. Given this, we want to anchor the long leg of the trade as close as possible and therefore opt for the 1Y sector. The choice of the short duration leg is in the 5Y sector as we expect the 5Y sector to underperform in the 2s/5s/10s swap fly in a sell off, as has been the case recently (**Exhibit 6**). 3M carry on the steepener is around -2bp versus around -9bp for outright short in 5Y yields.

We have a medium term bias toward narrower swap spreads in the 10Y sector. Swap spreads have been narrowing over the past few months. However, they are still well above their April lows before the Riksbank

Exhibit 6: We expect 5Y underperformance in a sell off; convert 2s/10s steepener into 1s/5s steepener

2s/5s/10s SEK 50:50 swap fly regressed against 5Y SEK swap yield; since 1 Jan 2015; bp

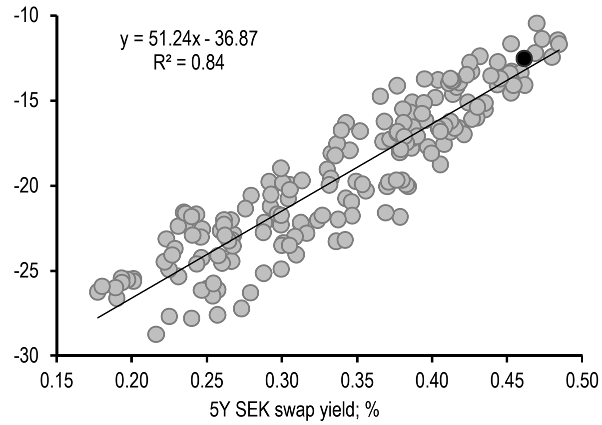


Exhibit 7: Since the surprise QE extension in April, Swedish swap spreads have failed to reach its prior lows. We recommend 10Y Sweden swap spread narrowers…

SGB May 2028 swap spread; since Jan 2017; bp

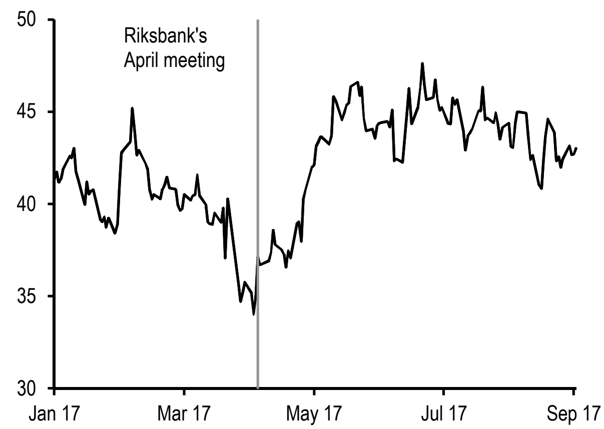
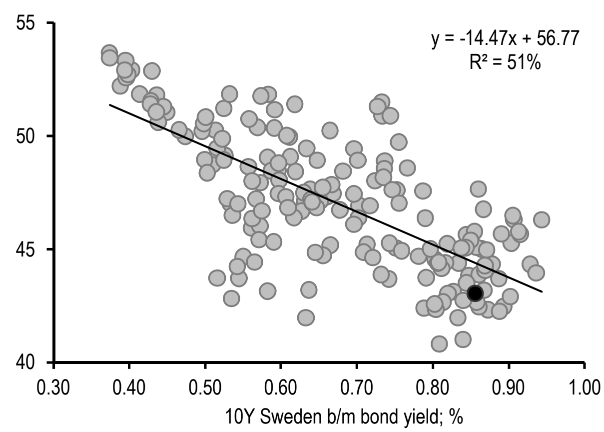


Exhibit 8: …which is also supported by our call for higher rates

10Y Sweden b/m swap spread regressed against 10Y Sweden b/m bond yield; since 1 Jan 2017; bp



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surprised with extending its sovereign QE program into 2H17 (**Exhibit 7**). Going forward, we expect the Riksbank to end the asset purchases after this round in December 2017, although reinvestment of maturing principals and coupons is likely to continue over the near future. A strong currency and Riksbank's focus on it has kept swap spreads wide but we believe that macro conditions do not warrant any further increase of QE and the residual QE premium on the swap spread will slowly fade. **We recommend 10Y swap spread narrowers** as a bearish duration proxy (see *Trade Recommendations*). Additionally, this trade is also a short duration proxy (**Exhibit 8**).

On a cross market basis, last week **we had recommended entering longs in Mar18 Short Sterling vs. shorts in SEK Mar18 FRA** on a view that the dichotomy between a hawkish BoE and dovish Riksbank despite domestic economic conditions suggesting the opposite. As shown in **Exhibit 9**, we expect further pickup in Swedish inflation on better growth fundamentals and wage pressure from a positive output gap whereas benign growth, fading of the FX related inflation boost, and Brexit uncertainty would pressure UK inflation lower thereby releasing some pressure from the BoE. In other words, risks are for an earlier hike by the Riksbank whereas a slower pace of hike by the BoE. The SEK/GBP spread has moved around 2bp against us over the past week and **we continue to hold this trade**. Risks to our view could come from the Riksbank willing to tolerate more persistent inflation overshoots and/or that BoE's reaction function has shifted more fundamentally in a hawkish direction.

Norway

The Norges Bank kept its policy rate constant but marginally steepened its rate forecast trajectory (**Exhibit 10**). The first hike was moved marginally forward from 4Q19 to 3Q19. The hawkish adjustment to its policy path was due to a combination of factors. On the domestic side, the central bank expects the mainland GDP to remain close to 2% which is also expected to reduce the level of slack; the Norges Bank expects the output gap (currently at -1.1%) will turn positive in 2020. Alongside inflation is also expected to pick up in 2019 and 2020 and move closer to its target of 2.5%. Overall, it adjusted its policy path for 2019 and higher.[21]

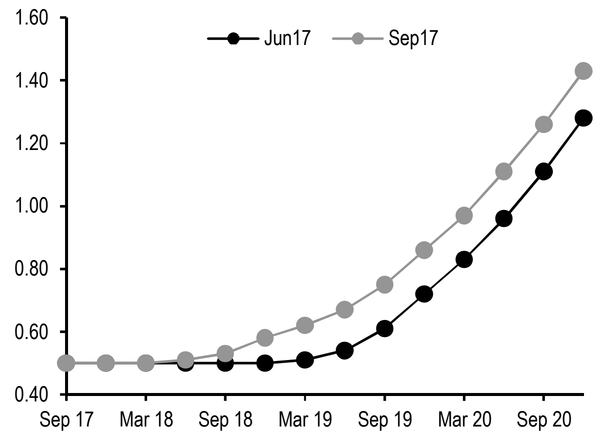
Exhibit 9: Given the dichotomy in macro backdrop for GBP and Sweden, we recommend paying Mar18 Sweden FRA's versus Germany

%oya

	GDP		Inflation	
	2017	2018	2017	2018
UK	1.60%	1.50%	2.90%	2.30%
Sweden	2.70%	2.40%	1.80%	2.20%

Exhibit 10: The Norges bank revised its rate trajectory modestly higher at the long end

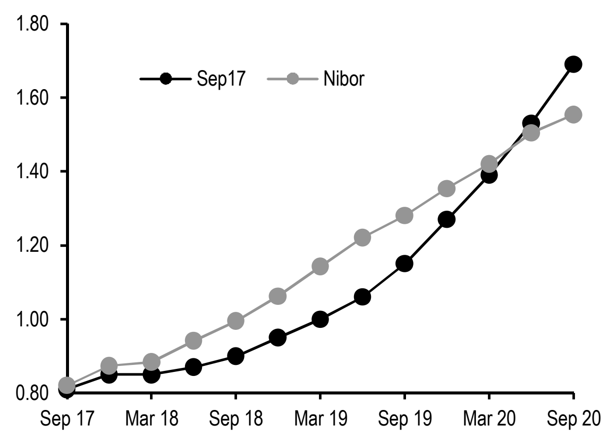
Norway repo rate; June2017 versus September2017 forecast; %



Source: Norges Bank and J.P.Morgan.

Exhibit 11: We think that the money market curve is too flat versus NB's forecast and macro fundamentals; Initiate fronts/greens Nibor curve steepeners

Projected 3M Nibor yield versus market impled 3M forwards; %



Source: Norges Bank and J.P.Morgan.

[21] This stands at cross roads with the Riksbank which despite boosting its output gap by around 1%, refused to do any hawkish revision to its forecast across the entire trajectory.

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The Nibor curve is pricing a marginally aggressive policy rate trajectory over the next couple of years - our own forecast is for them to hike rates in June 2019. However, greens/blues Nibor yields appear modestly cheap versus central bank trajectory (**Exhibit 11**). We believe that a global push toward higher yields will drag Nibor yields higher and the curve steeper (given that hiking prior to mid-2019 is rather difficult. Therefore, to position for increasing term premium on the curve, **we recommend fronts/greens Nibor curve steepener** (see *Trade Recommendations*). We like to anchor the short duration leg at the front-end of the curve where the repricing is expected to be limited.

Trade recommendations

High-conviction trades are starred (★). All other recommendations are moderate-conviction

- **Initiate 1s/5s SEK swap curve steepener**
  – Pay SEK 100mn 3Mx5Y swaps (swap start date 27 Dec 2017, swap end date 27 Dec 2022) versus receiving SEK 495mn 3Mx1Y swaps (swap start date 27 Dec 2017, swap end date 27 Dec 2018) to enter into a 1s/5s swap curve steepener at 87.4bp;

- **Open 10Y Sweden swap spread narrower**
  – Enter 10Y Sweden benchmark (SGB May 2028) swap spread narrower at 43bp;

- **Fronts/greens Nibor curve steepener**
  – Pay NOK 100mn 27Mx1Y Nibor swaps (swap start date 27 Dec 2019, swap end date 28 Dec 2020) versus receiving NOK 98mn 3Mx1Y Nibor swaps (swap start date 27 Dec 2017, swap end date 27 Dec 2018) to enter into a fronts/greens Nibor curve steepener at 54.8bp;

- **Take profit in 2s/10s SEK swap curve steepener**
  – Close paying SEK100mn 3Mx10Y Stibor swaps (swap start date 22 Nov 2017, swap end date 22 Nov 2027) versus receiving SEK 478mn 3Mx2Y Stibor swap (swap start date 22 Nov 2017, swap end date 22 Nov 2029) at 139bp versus entry level of 136bp; P/L since inception: +3bp of yield;

- **Stay short SGBi22 real yield**
  – Sell SGBi22 inflation linked bond at -1.76% versus current level of -1.83% (*Monthly Inflation Outlook*, 16th August 2017); P&L since inception -6.6bp of yield;

- **Stay short Mar18 SEK vs GBP FRA**
  – Remain in short Mar18 SEK FRA versus Mar18 GBP FRA at -1.02% versus current level of -1.04% (GFIMS 15 Sep 2017); P&L since inception: -2bp of yield;

- **Keep 1s/5s weighted SEK bear steepener**
  – Buy SEK 53mn 0.545% 3Mx5Y SEK payer (53% risk, notification date 10 Oct 2017, maturity date 12 Oct 2022) versus selling SEK 490mn -0.395% 3Mx1Y SEK payer (100% risk, notification date 10 Oct 2017, maturity date 12 Oct 2018) to remain in weighted 1s/5s bear steepener at 68.4bp versus forward and spot level of 60.6bp and 60.5bp; weighted spread defined as 0.53*5Y - 1Y (*GFIMS* 7th July 2017); P&L since inception: -8bp of notional;

- **Hold 2Y SEK/USD cross currency basis wideners**
  – Receive 3Mx2Y SEK/USD cross currency basis wideners at -21.1bp versus (entry level of -21.5bp); Total P/L since inception: -0.4bp of yield;

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Trades closed over the past 12 months

TRADE	ENTRY	EXIT	P&L
DURATION			
Receive reds Stina	23-Nov-16	10-Feb-17	-12.5
Rec Dec17 SEK FRAs	10-Feb-17	10-Mar-17	1.3
6Mx2Y SEK rec spreads vs payer spreads	10-Feb-17	10-Mar-17	2.0
Buy 3Mx10Y 1x2 payer spread	09-Jun-17	21-Jul-17	1.2
Buy 3Mx1Y receiver spread	21-Jul-17	08-Sep-17	0.5
CURVE / SWAP SPREADS			
2s/10s SEK steepener vs beta wtd EUR	16-Sep-16	30-Sep-16	6.5
Reds/blues Nibor curve steepeners	16-Sep-16	14-Oct-16	7.0
2s/10s SEK weighted bear steepener	16-Sep-16	04-Nov-16	3.1
Level adjusted 2s/10s SEK boond curve flattener	04-Nov-16	09-Dec-16	-12.6
Short 5Y in 2s/5s/10s SEK swap fly	18-Mar-16	09-Dec-16	-7.5
Greens/10Y Stibor swap curve steepener	23-Nov-16	20-Jan-17	-8.0
1s/10s SEK weighted bear steepener	23-Nov-16	10-Feb-17	0.3
10Y SEK swap spread narrower	23-Nov-16	10-Feb-17	6.0
1s/5s SEK weighted bull flattener	10-Feb-17	07-Apr-17	1.8
10Y SEK swap spread widener vs Germany	10-Feb-17	12-May-17	7.5
Reds/5Yx5Y SEK/EUR xccy curve steepener	07-Apr-17	12-May-17	8.5
1s/10s SEK weighted bear steepener	24-Feb-17	24-May-17	0.0
Pay 5Yx5Y SEK vs USD	24-Feb-17	09-Jun-17	0.0
Fronts/blues stibor curve steepener	28-Apr-17	04-Jul-17	14.0
1s/5s SEK weighted bear steepener	28-Apr-17	07-Jul-17	4.4
10Y SEK swap spread narrower	09-Jun-17	21-Jul-17	3.0
Rec 5Yx5Y SEK vs USD	09-Jun-17	18-Aug-17	8.5
1s/10s SEK weighted bull flattener	09-Jun-17	18-Aug-17	0.1
2s/10s SEK curve vs EUR	10-Mar-17	18-Aug-17	-11.0
Fronts/Blues stina curve flattener	18-Aug-17	08-Sep-17	8.6
10Y (SEK-EUR) bear widener	10-Mar-17	08-Sep-17	0.0
2s/10s SEK swap curve steepener	18-Aug-17	22-Sep-17	3.0
COUNTRY SELECTION / RELATIVE VALUE			
3Mx1Y (NOK - SEK) widener	19-Aug-16	30-Sep-16	13.0
3Mx10Y (SEK - EUR) bull narrower	16-Sep-16	14-Oct-16	1.4
5Yx5Y SEK/EUR cross currency basis	15-Sep-16	14-Oct-16	7.0
3Mx10Y (SEK - EUR) bull narrower	14-Oct-16	04-Nov-16	2.6
3Mx10Y SEK/USD cross currency basis	15-Sep-16	04-Nov-16	3.7
3Mx10Y (SEK-EUR) weighted bear widener	16-Sep-16	09-Dec-16	-6.0
2Yx1Y (NOK -SEK) yield spread widener	23-Nov-16	20-Jan-17	-24.3
2Yx1Y (NOK -EUR) yield spread widener	23-Nov-16	10-Feb-17	-2.0
Sell 10Y SGB versus Bunds	09-Jun-17	21-Jul-17	2.5
1Yx1Y (SEK-EUR) widener	10-Feb-17	21-Jul-17	-8.0
2Yx1Y (SEK-NOK) widener	24-Mar-17	21-Jul-17	-10.0
INFLATION			
Long 10Y SEK breakeven	10-Jun-16	04-Nov-16	3.0

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Japan

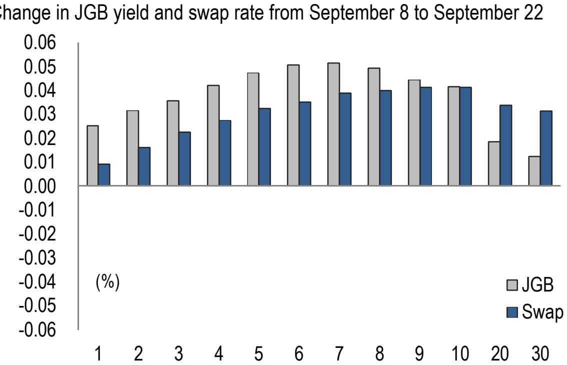
- **Over the last 2 weeks, JGB curve bear flattened, retracing most of the gain from the heightened tension over North Korea earlier this month.**
- **Prime Minister Abe is preparing for a snap election on October 22: implications for JGB are (1) YCC will be even more secure as PM Abe has higher chance of staying in power after his second term, (2) slightly positive for Japan's financial stability as VAT hike next October looks more likely.**
- **Uneventful BoJ MPM: we can arguably say that the BoJ board has become more dovish after the reshuffle of board members, but policy implication is limited.**
- **3m JPY T-bill yield has taken a round trip in the last two months, reaching -20bp in late August and coming back up to near -10bp. Going forward: (a) we envisage that there will be some support around -10bp as there will be an arbitrage opportunity and (b) the BoJ may calibrate their purchase pace.**
- **Monthly Inflation Outlook: we turn tactically bullish on Japanese BEI. Main thesis for our call is the rise in likelihood of VAT hike. 8=>10% hike translates to an instant boost in BEI of around 10bp. Moreover, if reduced tax rate is not introduced, BEI will gain another 4-5bp. Furthermore, other factors also support BEI in the next few months, notably (i) cheap valuation, (ii) favorable supply demand outlook, (iii) slightly positive CPI carry, and (iv) floor premium.**
- **JSDA JGB Transaction August: even amid North Korean risk-off sentiment, we didn't witness any active buyers in JGB universe. August transaction data shows how few investors expect yields to go further down under YCC framework.**

Overview

Over the last 2 weeks, JGB curve bear flattened, retracing most of the gain from the heightened tension over North Korea earlier this month (Exhibit 1). JGB yields rose the most around 7y by 5-6bp because JGB futures outperformed the most during the risk-off period. On the other hand, 20y and 30y were well bid especially this week, only rising by 2-3bp. This is not only in line with recent bear flattening trend of UST, but also reflects persistent demand from domestic investors going into end of 1H.

Going forward, short-term outlook for JGB stays obscure as it will continue to be highly sensitive to headlines related to North Korea and movement of USDJPY and/or Nikkei 225. In the long run, we continue to expect 10y JGB to be traded in the range of 0-5bp under YCC. With rising probability of snap election next month, we believe YCC will be even more secure (discussed in the next chapter). As for other parts of the curve, we still have a mild steepening bias on super-long end later in 2017, given lack of demand from investors (observed from JSDA transaction data; discussed in the later chapter) and limited support from the BoJ compared to 10y.

Exhibit 1: JGB curve bear flattened as a reversal of NK risk-off
Change in JGB yield and swap rate from September 8 to September 22



Source: J.P. Morgan

Abe to hold a snap election on Oct 22: YCC to be even more secure

Over the long weekend (September 16-18), various media reported that Prime Minister Abe is preparing for a snap election to be held on October 22 (See *report by Japan Economics team*). The decision was made most likely in view that the LDP will be able to win at least the 1/2 majority with recent recovery of approval rating (46% Nikkei based as of 27 August) and turbulence the opposition party (the Democratic Party) is facing. Furthermore, "Tomin First no Kai" led by Yuriko Koike, which had a historic victory against the LDP in Tokyo Metropolitan Assembly Election in July, will unlikely be fully prepared for a Diet election yet.

There are two implications to JGB market. First, the most important one is that sustainability of YCC will become even more robust. If the LDP wins the majority, likelihood of Abe's re-election as the LDP leader after his 2nd term would rise. As long as PM Abe stays in power, the current excessively loose monetary policy will likely be kept in order to keep Abenomics going. Therefore, he would choose Kuroda or someone with similar policy priority as Kuroda for the next BoJ governor and YCC will likely be kept.

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Second, it might be slightly positive for Japan's financial stability as likelihood of VAT hike will rise. PM Abe reportedly plans to make a commitment on expansion of child care support and free education in the campaign and he intends to hike VAT from 8% to 10% in October 2018 to finance this. Although part of the tax revenue will be spent on the government expenditure above, most of it will still be used for JGB redemption. Therefore, given that many had anticipated another postponement of VAT hike, this news may be considered slightly positive for Japan's sovereign rating.

Uneventful BoJ MPM (as usual)

On September 21, the BoJ held Monetary Policy Meeting. This was the first MPM joined by new board members Hitoshi Suzuki and Goushi Kataoka replacing Takahide Kiuchi and Takehiro Sato, the only two monetary hawks on the BoJ board. In short, everything, including short-term rate (-0.1%), 10y yield target (around 0%) and JGB purchase amount (JPY 80tn/year), was kept unchanged as expected.

The only surprise was that the continuation of YCC was passed by 8:1 votes, with Kataoka opposing the proposal. According to the BoJ's document, Kataoka has called for a more dovish shift in monetary policy, arguing that 2% inflation target is not achievable with the current YCC framework. Note, in previous MPMs, YCC had been passed by 7:2 votes, with the two hawks, Kiuchi and Sato, dissenting from the majority calling for a hawkish shift.

From this MPM, we can arguably say that the BoJ board has become more dovish after the reshuffle of board members. Nevertheless, we emphasize that such shift is unlikely to have any material impact on BoJ policy decisions because the majority led by Kuroda will continue to dominate the scene either way.

Recent weakness of T-Bill

3m JPY T-bill yield has taken a round trip in the last two months, reaching -20bp in late August and coming back up to near -10bp. Initially, 3m yield had declined throughout August, most likely reflecting both (1) foreign demands for an extra pick-up through USDJPY cross-currency basis and (2) domestic demands to increase bond position in a risk-off market. Against this backdrop, 3m yield declined to below -20bp, the lowest level since April (Exhibit 2).

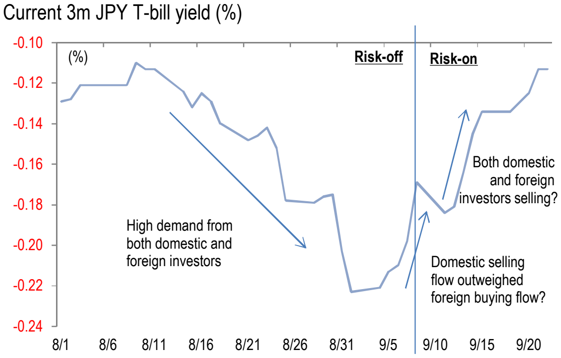
However, since the beginning of September, the trend reversed and 3m yield made its way back up to -11bp today. It was slightly puzzling since data from the MoF showed that foreign investors bought JPY1.8tn of short-term debt during September 2-9 (see link). We envisage profit taking operation by domestic investors probably outweighed the opposite flow from foreign investors during this period. Thereafter, 3m yield further rose the following week as foreigners held back on JGB$ASW presumably because of tighter 3m USDJPY xccy basis.

What do we expect from here? First, we envisage that there will be some support around -10bp as there will be an arbitrage opportunity against negative interest rate on BoJ current account balance.

Second, we may see some changes in action from the BoJ. If they see the recent underperformance of T-bill to be a threat to YCC, they may curb the pace of reduction. The BoJ have been reducing purchase amount currently at pace of JPY 1tn per month (Exhibit 3), but we need to keep an eye on how purchase amount may change and what their end of September T-bill holding number would be to understand their view on current T-bill.

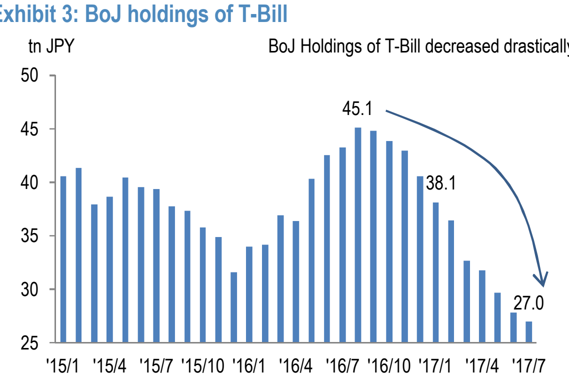
Exhibit 2: 3m T-bill yield took a round trip in the last 2 months

Current 3m JPY T-bill yield (%)



Source: J.P. Morgan

Exhibit 3: BoJ holdings of T-Bill



Source: J.P. Morgan

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Monthly Inflation Outlook (published September 20)

Overview

Turn tactically bullish on Japanese BEI as VAT hike looks more likely

In our previous publications of MIO, we have continuously argued that Japanese BEI has been left cheap in many aspects, but could not find the right timing to enter a long position. We take this opportunity to turn tactically bullish on Japanese BEI.

Main thesis for our call is the rise in likelihood of VAT hike. As Prime Minister Abe is reportedly planning on holding a snap election on October 22nd, 8=>10% VAT hike in October 2019 looks more likely, given Abe intends to make a commitment on expansion of child care support and free education financed by VAT hike.

If we assume VAT hike (8=>10%) to take place within the next 10 years with reduced tax rate for food items (except dining out), impact on CPI will be 1.02% (=1.85% (effect of VAT hike: 110/108-1)×0.55(pass-on ratio to consumers)). This translates to an instant boost in BEI of around 10bp.

Previously, we had believed that there was a reasonable chance of VAT hike getting postponed again to avoid adverse effect on the economy. Against this backdrop, VAT hike premium on JGBi was less visible in the short term. However, with the recent change of atmosphere, it seems we entered a stage to price in this premium with a fair amount of certainty.

Moreover, media has been muted about the implementation of reduced tax rate and there is speculation that VAT hike may not be accompanied by reduced tax rate. In that case, pass-on ratio could be as high as 0.80 instead of 0.55. Therefore, under this scenario, BEI will gain another 4-5bp on top of the above. Although evidence to support this story is still weak, it may provide us with potential upside if it materializes.

Furthermore, other factors also support BEI in the next few months, notably (1) cheap valuation, (2) favorable supply demand outlook, (3) slightly positive CPI carry, and (4) floor premium, which will be discussed in detail in the next chapter. Against this backdrop, we decided to put up a trade to go long JGBi#22 on breakeven basis.

Investment themes

Theme 1: BEI is still cheap from historical and relative value perspective

Since the last publication of our Monthly Inflation Outlook in August, Japanese BEI has edged down to as low as sub-0.3%, hitting its trough since summer 2016. During this time, not only energy price modestly declined, but nominal yields of government bonds declined worldwide, with current 10y JGB yield reaching 0% in the beginning of September.

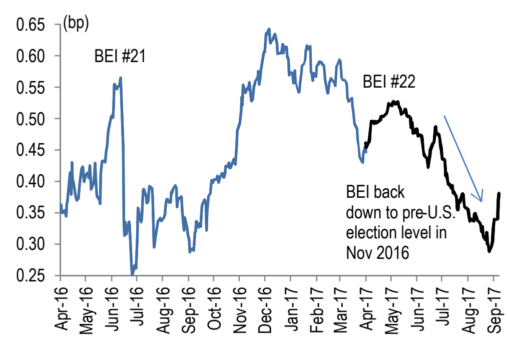
More recently, it has started to reverse since last week in sympathy with the rise of global BEI on the back of global yield rise and recovery in oil price. The gain this week (about 5bp) most likely reflects expectation for VAT hike too. Nevertheless, it still remains low at around pre-U.S. election level (Exhibit 4).

Furthermore, from relative value perspective, the current BEI has been underperforming against the level suggested by our regression model over USDJPY and WTI by just under 10bp (Exhibit 5). Discrepancy has narrowed in the last few days, but there is still gap to be filled. Moreover, Japanese BEI has underperformed against U.S. BEI by just under 10bp as well (Exhibit 6).

In conclusion, we can still say that the current Japanese BEI is still cheap from historical as well as from relative value perspective despite recent rally and we can still expect some upside from this level.

Exhibit 4: Japanese BEI declined to as low as sub-0.3%, but recovered to pre-U.S. election level in the last few days

Japanese BEI (#21/22) since April 2016



Source: J.P. Morgan

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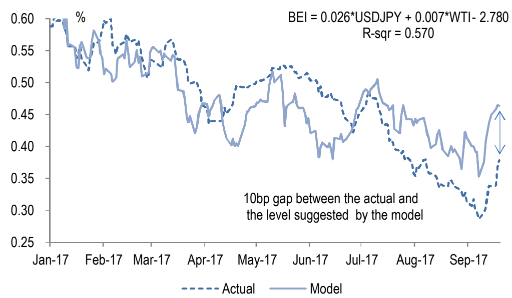
Exhibit 5: Regression model points to a 10bp pick up in BEI from the current level

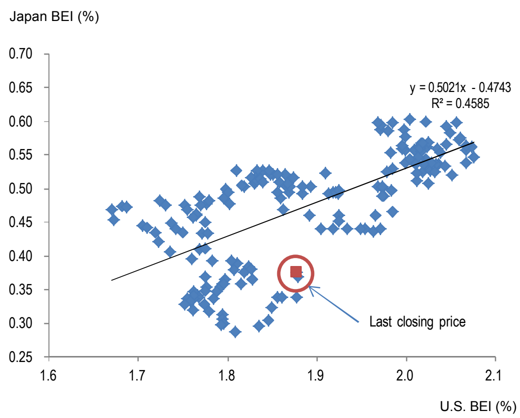
Modelled BEI (regression over USDJPY and WTI) vs. actual BEI



Source: Bloomberg, J.P. Morgan

Exhibit 6: Japanese BEI underperformed U.S. BEI by 10bp based on historical correlation (Since 2017)

Japanese BEI vs. U.S. BEI



Source: Bloomberg, J.P. Morgan

Theme 2: supply demand outlook is favorable

JGBi auctions are currently being held in February, April, August, and October, meaning that there is a four-month gap after October auction, which will be held in 2 weeks.

After supply of JPY400bn on October 5, the BoJ are set to buy JPY50bn per month and the MoF are set to buy JPY20bn every two month for total absorption of JPY240bn over the four-month inter-auction period. This will leave JPY160bn in net supply (Exhibit 7). If we consider purchase from domestic pension funds (they generally buy about half of the auction amount, which equals JPY 200bn), supply demand condition seems tight, offering buying opportunity for investors.

Exhibit 7: Supply demand condition is favorable

October (4 months gap between auctions)

Type	# offered	Amount/op	Amount
Issuance	1	× 400bn/issuance	+400bn
MoF Buyback	2	× 20bn/op	-40bn
BoJ Purchase	8	× 25bn/op	-200bn
Net Supply			**+160bn**

Source: MoF, BoJ, J.P. Morgan

Theme 3: CPI carry is slightly positive

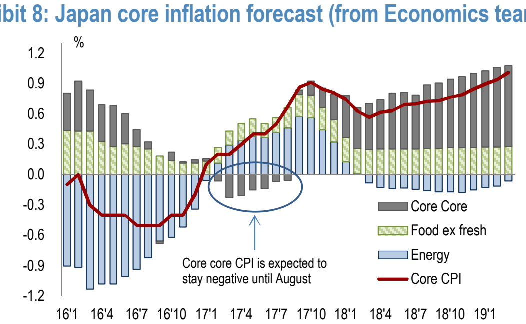
Core CPI has been sluggish, but slowly recovering

In July, nationwide core CPI (ex. fresh food only; benchmark for JGBi) increased 0.5%yoy, supported mainly by the lagged effect of energy price rise. Turning our eyes to core core CPI (ex. food and energy), it continued to decline modestly at -0.1%yoy as inflation momentum other than energy price remains soft. However, despite lack of any signs of recovery in underlying inflation, it is still true that core CPI has kept its upward trend for the last few months.

Going forward, our economics team forecasts a modest pick-up in core CPI over lagged contribution from energy (Exhibit 8). We see a downside risk to this view as historical pattern suggests that energy contribution, which generally takes effect with 3 months lag, seems to have peaked out already (Exhibit 9). However, on the other hand, historical pattern suggests that the USDJPY depreciation since late 2016 may start pushing up core core CPI through rise in price of imported goods with 9 months lag (Exhibit 10). This will probably provide support for core and core core CPI, partially offsetting the potential weakness from energy price.

All in all, although the pace of recovery is sluggish, downside risk for core CPI seems limited from the current level, provided USDJPY and WTI hold up.

Exhibit 8: Japan core inflation forecast (from Economics team)



Source: J.P. Morgan

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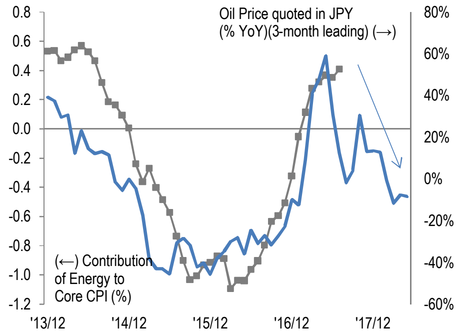
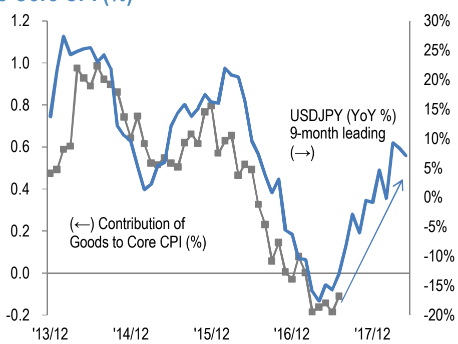
Exhibit 9: Oil Price (quoted in JPY) (3-month leading) vs. Contribution of "Energy" to core CPI



Source: J.P. Morgan
Note: The diagram assumes current USDJPY and WTI level to stay unchanged for the next 6 months

Exhibit 10: USDJPY (yoy %) (9-month leading) vs. Contribution of Goods to Core CPI (%)



Source: J.P. Morgan
Note: The diagram makes no assumption about future USDJPY level

Analysis on CPI carry

Exhibit 11 shows the analysis of CPI carry simulated using our economics team's core CPI forecast. June core CPI (100.2) is used for the notional calculation for September and July core CPI (100.1) is used for October.

Looking ahead, our economics team forecast a modest rise in core CPI in August (100.3), followed by a reasonable pick up in fall (100.5 in Sep, 100.7 in Oct, and 100.6 in Nov).

Therefore, for example, if we purchase JGBi on September 10, and hold it until January 10, 2018, we can expect CPI carry of 50sen, assuming zero change in price. Although we see downside risks to the core CPI projection above, CPI carry will likely be slightly positive or neutral at least in the next few months.

Exhibit 11: Core CPI was 100.1 in July and is expected to rise for the next few months

Analysis of CPI carry using core CPI projection

CPI Date	Applied Date	Core CPI	Realized/ Projection
Jun-2017	2017/9/10	100.2	Realized
Jul-2017	2017/10/10	100.1	Realized
Aug-2017	2017/11/10	100.3	Projection
Sep-2017	2017/12/10	100.5	Projection
Oct-2017	2018/1/10	100.7	Projection
Nov-2017	2018/2/10	100.6	Projection

Source: Ministry of Internal Affairs and Communications, J.P. Morgan

Theme 4: Floor premium will provide some support against downside risk

We estimate the Floor premium to be around 10.3bp

We estimate the value of the floor option embodied in JBI22 (stemming from the fact that full repayment of principal is guaranteed at maturity) at around 98sen, which translates into a contribution of around 10.3bp to the BEI (Exhibit 12). Although we should stress that this estimate is quite sensitive to our various underlying assumptions, floor premium should provide some support for a potential downside risk (Note: this premium should decline close to zero if VAT hike actually takes place).

Exhibit 12: JGB linkers Floor Premium analysis

Sep/19	Close	Real Yield (%)	BEI (bp)	Maturity (yr)	Floor Yield (bp)	Floor Price (sen)
JBI17	103.35	-0.45	36.11	5.97	0.58	4
JBI18	103.60	-0.45	36.68	6.47	1.50	10
JBI19	103.95	-0.46	38.60	6.98	7.03	50
JBI20	103.95	-0.42	35.95	7.47	7.92	60
JBI21	104.20	-0.39	36.27	8.47	9.38	80
JBI22	104.50	-0.37	37.68	9.47	10.26	98

Source: J.P. Morgan

JSDA JGB Transaction August (published September 20th)

JSDA Bond Transactions data for August 2017 was released on 20 September 2017. In August, JGB yields continuously declined amid heightened geopolitical tension with North Korea, with 10y yield reaching almost 0% towards the end of the month. It is worth highlighting the market activities by investors during this period, therefore we would like to reflect on this data point.

Super-long sector

Exhibit 13 shows the data for super-long sectors (20Y, 30Y, 40Y and 15Y floating-rate JGBs)

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- Insurers: Insurers net bought JPY120bn in August, the least since April. Average net purchase pace between April and August was JPY170bn/month, much lower than JPY 300bn last year. Insurers probably refrained from purchasing at low yield level especially since cash inflow into lifer's wallet has decreased since April.
- Banks: City banks net bought JPY 390bn in August, up from JPY 140bn in July. Considering direct sales through Rinban, they were probably involved in more of trading activities, rather than extending their long positions.
- Regional banks, trust banks and others: Regional banks, trust banks and others net sold total of JPY 410bn in August. We believe they took profit as yields decline. Moreover, part of the sale may be a result of their covered call strategy. There were only few notable buyers of super-long JGB even in a risk-off environment like August.

Long sector

Exhibit 14 shows the data for long sector (10Y and 10Y inflation-linked JGBs)

- City banks: City banks net sold JPY 770bn in August, the largest net sales since October 2015. We believe they unwound part of their position as 10y yield approach 0%.
- Other domestic investors: Regionals, agricultural banks and trust banks were all net sellers of long JGB. Domestic investors, in aggregate, net sold JPY 2,400bn of long JGB this month.
- Foreigners: Foreigners net bought JPY 940bn in August, up from JPY 40bn in July.

Intermediate sector

Exhibit 15 shows the data for intermediate sector (2Y and 5Y)

- City banks and others: City banks net bought JPY 600bn in August after net selling JPY 190bn in July. Other domestic investors stayed quiet.
- Foreigners: Foreigners net bought JPY 1,920bn in August, up from 700bn in July. As USDJPY cross-currency basis widened from -42bp to -54bp during the month of August, demand for JGB$ASW surged.

Summary/implication

- Even in this North Korea related risk-off environment, we didn't witness any active buyers in JGB universe. The transaction data this month shows how few investors expect yields to go further down under YCC framework.
- As 10y yield approach 0%, almost all domestic investors net sold long JGB with the total net sales amount reaching JPY 2,400bn this month. It seems net purchase from foreign investors were driving yields to decline in August. We believe JGB yields under 10y will continue to be range-bound going forward.
- Insurers only net bought JPY 170bn/m of super-long JGB on average in April-August. Moreover, regional banks have been net selling super-long JGB so far this year. Even in a risk-off environment, demand for 30y and 40y JGB will unlikely rise. We reiterate the risk of a steeper curve later in 2017, considering the lack of underlying demand from investors.

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Exhibit 13: JSDA Bond Transactions data, Super-long sectors (20Y, 30Y, 40Y and 15Y floating-rate JGBs)

	Super-long (JPY bn)	FY14	FY15	FY16	FY16-4Q	FY17-1Q	'17/06	'17/07	'17/08	Purchase	Sales
Net Purchase	City banks	0	90	-40	-10	70	220	140	390	940	550
	Regional banks	60	30	-20	-80	-50	-90	0	-60	180	240
	Second regional banks	-10	10	10	-20	-10	-20	30	-60	40	100
	Shinkin banks	0	10	0	-60	-10	60	50	-220	60	280
	Other financial institution	20	20	20	60	40	30	0	-50	20	70
	Agricultural financial institution	240	150	130	250	110	190	220	10	350	340
	Life and non-life insurers	380	320	340	380	170	160	250	120	320	200
	Trust banks/Investment trusts	-170	0	200	310	150	180	50	110	1,550	1,440
	Foreigners	270	-90	60	280	270	380	-40	50	1,000	950
	Others	20	10	20	30	0	0	30	-20	30	50
	JP Bank/Insurance + direct + etc	290	110	190	230	130	280	-110	-310		
Subtotal	BoJ	1,380	2,180	1,870	1,640	1,790	2,010	1,720	2,080		
	City + Agricultural + Insurers + JP Bank	910	670	620	850	480	850	500	210		
	Regional + Others	90	80	30	-70	-30	-20	110	-410	330	740
	Trust banks/Investment trusts	-170	0	200	310	150	180	50	110	1,550	1,440
	Foreigners	270	-90	60	280	270	380	-40	50	1,000	950
	Total	2,480	2,840	2,780	3,010	2,660	3,400	2,340	2,040	0	0

Source: JSDA, J.P. Morgan

Exhibit 14: JSDA Bond Transactions data, Long sectors (10Y and 10Y inflation-linked JGBs)

	Long (JPY bn)	FY14	FY15	FY16	FY16-4Q	FY17-1Q	'17/06	'17/07	'17/08	Purchase	Sales
Net Purchase	City banks	-420	-10	50	-220	340	450	70	-770	770	1,540
	Regional banks	20	-80	-50	-260	-50	90	60	-490	90	590
	Second regional banks	20	0	-10	-30	10	20	90	-120	10	140
	Shinkin banks	50	-30	-10	-10	-40	70	90	-310	0	310
	Other financial institution	10	-70	-40	-80	-110	-10	40	-40	20	60
	Agricultural financial institution	30	-20	-50	-20	-190	30	-10	-20	10	40
	Life and non-life insurers	-30	-50	-60	-50	-20	20	10	-40	50	90
	Trust banks/Investment trusts	-180	70	-60	60	-270	60	190	-30	1,070	1,110
	Foreigners	260	410	330	-120	350	-60	40	940	2,250	1,310
	Others	30	0	-20	-10	0	-10	0	-10	10	20
	JP Bank/Insurance + direct + etc	220	140	80	-20	-50	40	360	-570		
Subtotal	BoJ	2,670	2,650	2,840	2,970	2,900	2,730	2,970	2,770		
	City + Agricultural + Insurers + JP Bank	-200	60	20	-310	80	540	430	-1,400		
	Regional + Others	130	-180	-130	-390	-190	160	280	-970	130	1,120
	Trust banks/Investment trusts	-180	70	-60	60	-270	60	190	-30	1,070	1,110
	Foreigners	260	410	330	-120	350	-60	40	940	2,250	1,310
	Total	2,680	3,010	3,000	2,210	2,870	3,430	3,910	1,310	0	0

Source: JSDA, J.P. Morgan

Exhibit 15: JSDA Bond Transactions data, Intermediate sectors

	Intermediate (JPY bn)	FY14	FY15	FY16	FY16-4Q	FY17-1Q	'17/06	'17/07	'17/08	Purchase	Sales
Net Purchase	City banks	-560	-740	-170	0	370	1,560	-190	600	2,420	1,820
	Regional banks	110	-30	-50	-30	-10	80	-20	10	100	90
	Second regional banks	30	-30	0	0	-20	-40	0	0	0	0
	Shinkin banks	0	-20	-50	-70	-10	0	0	0	0	0
	Other financial institution	-50	20	-50	-80	-10	0	20	-50	10	50
	Agricultural financial institution	30	20	10	0	0	20	0	0	10	0
	Life and non-life insurers	50	-10	-40	-20	-10	-10	-10	0	80	80
	Trust banks/Investment trusts	500	-150	-130	-380	90	260	-40	-160	1,360	1,520
	Foreigners	900	1,370	1,440	1,420	910	370	700	1,920	3,030	1,110
	Others	150	60	-20	-20	10	0	-10	-10	0	10
	JP Bank/Insurance + direct + etc	1,360	-110	-310	70	0	680	-570	-120		
Subtotal	BoJ	3,780	4,540	4,580	4,420	3,400	3,310	3,560	3,320		
	City + Agricultural + Insurers + JP Bank	880	-840	-510	50	360	2,250	-770	480		
	Regional + Others	240	0	-170	-200	-40	40	-10	-50	110	150
	Trust banks/Investment trusts	500	-150	-130	-380	90	260	-40	-160	1,360	1,520
	Foreigners	900	1,370	1,440	1,420	910	370	700	1,920	3,030	1,110
	Total	6,300	4,920	5,210	5,310	4,720	6,230	3,440	5,510	0	0

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Source: JSDA, J.P. Morgan

Exhibit 16: JSDA Bond Transactions data, Super-long, Long and Intermediate sectors (Total)

	Super-long+Long+Intermediate (JPY bn)	FY14	FY15	FY16	FY16-4Q	FY17-1Q	'17/06	'17/07	'17/08	Purchase	Sales
Net Purchase	City banks	-980	-660	-160	-230	780	2,230	20	220	4,130	3,910
	Regional banks	190	-80	-120	-370	-110	80	40	-540	370	920
	Second regional banks	40	-20	0	-50	-20	-40	120	-180	50	240
	Shinkin banks	50	-40	-60	-140	-60	130	140	-530	60	590
	Other financial institution	-20	-30	-70	-100	-80	20	60	-140	50	180
	Agricultural financial institution	300	150	90	230	-80	240	210	-10	370	380
	Life and non-life insurers	400	260	240	310	140	170	250	80	450	370
	Trust banks/Investment trusts	150	-80	10	-10	-30	500	200	-80	3,980	4,070
	Foreigners	1,430	1,690	1,830	1,580	1,530	690	700	2,910	6,280	3,370
	Others	200	70	-20	0	10	-10	20	-40	40	80
	JP Bank/Insurance + direct + etc	1,870	140	-40	280	80	1,000	-320	-1,000		
Subtotal	BoJ	7,820	9,380	9,290	9,030	8,080	8,050	8,250	8,160		
	City + Agricultural + Insurers + JP Bank	1,590	-110	130	590	920	3,640	160	-710		
	Regional + Others	460	-100	-270	-660	-260	180	380	-1,430	570	2,010
	Trust banks/Investment trusts	150	-80	10	-10	-30	500	200	-80	3,980	4,070
	Foreigners	1,430	1,690	1,830	1,580	1,530	690	700	2,910	6,280	3,370
	Total	11,450	10,780	10,990	10,530	10,240	13,060	9,690	8,850	0	0

Source: JSDA, J.P. Morgan

Trade recommendations

High-conviction trades are starred (★). All other recommendations are moderate-conviction.

- **Hold Belly-richener on 50:50 weighted JGB 5s/10s/20s butterfly**
  - Long JPY 10bn of 10Y JGB#344 versus JPY 10bn of 5Y JGB#129 and JPY 2.5bn of 20Y JGB#158. P/L since inception is +3.1bp (recommended 23 Nov 2016)
- **Have a steepening bias on 7s 10s JGB**
  - Long JPY 14bn of 7Y JGB#335 versus JPY 10bn of 10Y JGB#347. P/L since inception is +3.4bp (recommended 7 Jul 2017)
- **Long Inflation-linked JGB #22 on breakeven basis (New)**
  - Buy Inflation-linked JGB #22 and sell 10y JGB#346 @ 39.21bp breakeven. (recommended 20 September 2017)

TRADE	ENTRY	EXIT	P&L
DURATION			
CURVE			
Long 10Y JGB#347 versus 30Y JGB#55	23-Jun-17	7-Jul-17	6
SWAP SPREADS			
Long 2y JPY ASW versus 20y JPY ASW	23-Nov-16	7-Apr-17	12
FX BASIS			
Pay 1y USDJPY Basis	23-Nov-16	24-Feb-17	11
Recieve 1y USDJPY Basis	3-Mar-17	7-Apr-17	-13
Pay 5y USDJPY Basis	23-Jun-17	30-Aug-17	-5
OPTIONS			
Buy 3mx20Y straddle versus 3mx10Y	23-Nov-16	24-Feb-17	1
INFLATION			
Buy Inflation-linked JGB#21 and sell 10y JGB#342 @ 43.8bps breakeven	4-Apr-17	20-Apr-17	6
Sell Inflation-linked JGB#22 and sell 10y JGB#346 @ 54.6bps breakeven	18-May-17	4-Aug-17	9

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Interest rate forecasts

		22-Sep*	Dec-17	Mar-18	Jun-18	Sep-18	YTD chg. (bp)
US	Fed funds	1.00-1.25	1.25-1.50	1.25-1.50	1.50-1.75	1.50-1.75	50
	3M Libor	1.33	1.55	1.55	1.80	2.05	33
	2Y bmk yield	1.43	1.60	1.75	1.90	2.10	23
	5Y bmk yield	1.86	2.00	2.10	2.20	2.35	-6
	10Y bmk yield	2.25	2.40	2.45	2.50	2.55	-18
	30Y bmk yield	2.78	2.95	2.95	2.95	2.95	-27
	2s/10s bmk curve	82	80	70	60	45	-41
	10s/30s bmk curve	53	55	50	45	40	-9
	2s/30s bmk curve	135	135	120	105	85	-50
	2Y swap spread	27	26	24	24	-	1
	5Y swap spread	9	10	9	9	-	5
	10Y swap spread	-3	-5	-5	-5	-	9
	30Y swap spread	-31	-40	-38	-38	-	17
Euro area	Refi rate	0.00	0.00	0.00	0.00	0.00	-
	Depo rate	-0.40	-0.40	-0.40	-0.40	-0.40	-
	3M Euribor	-0.33	-0.30	-0.30	-0.30	-0.30	-1
	2Y bmk yield	-0.69	-0.65	-0.60	-0.55	-0.50	11
	5Y bmk yield	-0.25	-0.15	-0.05	0.05	0.15	29
	10Y bmk yield	0.46	0.65	0.75	0.85	0.95	26
	30Y bmk yield	1.28	1.50	1.60	1.70	1.80	34
	2s/10s bmk curve	114	130	135	140	145	15
	10s/30s bmk curve	82	85	85	85	85	9
	2s/30s bmk curve	197	215	220	225	230	23
	2Y swap spread	52	54	52	50	48	-11
	5Y swap spread	50	52	50	48	46	-9
	10Y swap spread	42	38	34	32	30	0
	30Y swap spread	30	32	28	26	24	0
10Y spread	Austria	21	20	25	25	25	1
to Germany	Belgium	30	30	35	35	35	-4
(curve adj.)	Finland	16	15	20	20	20	-2
	France	31	30	35	40	40	-13
	Ireland	43	45	50	50	50	-16
	Italy	172	180	215	190	175	13
	Netherlands	13	15	20	20	20	-2
	Portugal	202	200	215	200	200	-154
	Spain	114	115	120	105	100	-2
	Wtd. peri. spread	152	155	179	158	148	-3

		22-Sep*	Dec-17	Mar-18	Jun-18	Sep-18	YTD chg. (bp)
UK	Base rate	0.25	0.50	0.50	0.75	0.75	-
	3M Libor	0.33	0.55	0.55	0.80	0.80	-4
	2Y bmk yield	0.44	0.45	0.60	0.75	0.90	40
	5Y bmk yield	0.76	0.75	0.80	0.85	0.90	35
	10Y bmk yield	1.36	1.25	1.45	1.60	1.75	13
	30Y bmk yield	1.92	1.80	1.95	2.05	2.15	6
	2s/10s bmk curve	92	80	85	85	85	-27
	10s/30s bmk curve	56	55	50	45	40	-7
	2s/30s bmk curve	148	135	135	130	125	-34
	2Y swap spread	35	31	31	29	27	-18
	5Y swap spread	32	31	28	25	25	-5
	10Y swap spread	6	7	7	5	3	9
	30Y swap spread	-27	-30	-30	-33	-35	16
Japan	Policy rate	-0.10	-0.10	-0.10	-0.10	-0.10	-
	10Y yield target	0.00	0.00	0.00	0.00	0.25	-
	2Y bmk yield	-0.13	-0.15	-0.10	-0.10	0.00	6
	5Y bmk yield	-0.10	-0.10	-0.05	-0.05	0.10	1
	10Y bmk yield	0.02	0.00	0.05	0.10	0.30	-2
	20Y bmk yield	0.55	0.60	0.70	0.75	1.00	-2
	30Y bmk yield	0.82	0.85	0.95	1.00	1.30	11
	2s/10s bmk curve	15	15	15	20	30	-7
	10s/30s bmk curve	80	85	90	90	100	13
	2s/30s bmk curve	95	100	105	110	130	5
Australia	Cash rate	1.50	1.50	1.25	1.00	1.00	-
	3Y bmk yield	2.14	2.30	2.05	1.80	1.75	16
	10Y bmk yield	2.81	2.75	2.65	2.50	2.45	5
New Zealand	Cash rate	1.75	1.75	1.75	1.75	1.75	-
	3Y bmk yield	2.23	2.25	2.20	2.10	1.90	-21
	10Y bmk yield	3.09	3.00	2.95	2.90	2.70	-25
Sweden	Repo rate	-0.50	-0.50	-0.50	-0.50	-0.40	-
	2-year govt	-0.69	-0.55	-0.45	-0.35	-0.25	-6
	10-year govt	0.88	1.05	1.25	1.50	1.75	34
Norway	Depo rate	0.50	0.50	0.50	0.50	0.50	-
	2-year govt	0.55	0.60	0.65	0.70	0.75	-18
	10-year govt	1.48	1.70	1.85	2.00	2.25	-15

* Levels as of 1:00PM London time.

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Marketable sovereign bond* and bank debt** redemptions

Bn of local currency (except for Japan which is in ¥trillion)

	Japan	Australia	Austria		Belgium		Finland		France		Germany		Netherlands		Core***	
	Sov.	Sov.	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks
Dec-16	21	0	0	0	0	0	0	0	0	6	14	6	0	2	14	13
Jan-17	3	0	0	3	0	1	0	0	0	12	20	3	11	11	31	30
Feb-17	3	12	10	1	0	0	0	0	22	9	16	6	0	3	48	19
Mar-17	21	0	0	2	10	1	0	2	0	8	14	5	0	6	24	24
Apr-17	3	0	0	0	0	0	5	0	29	11	18	3	12	4	64	17
May-17	3	0	0	0	0	1	0	1	0	4	0	4	0	4	0	14
Jun-17	18	0	0	1	13	0	0	0	0	7	13	4	0	2	26	14
Jul-17	3	15	0	3	0	0	0	0	41	8	19	7	13	3	73	21
Aug-17	3	0	0	2	0	0	0	0	0	3	0	6	0	2	0	12
Sep-17	19	0	8	2	8	0	6	1	0	9	13	10	0	2	35	24
Oct-17	3	0	0	0	0	0	0	0	35	10	16	3	0	5	51	19
Nov-17	3	0	0	0	0	1	0	0	0	5	0	2	0	3	0	12
Dec-17	17	0	0	0	0	1	0	0	0	2	13	2	0	1	13	7
Total	120	26	18	14	31	6	11	4	127	94	156	60	35	47	378	225

	Greece		Ireland		Italy		Portugal		Spain		Periphery****		US		UK		Sweden
	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.	Banks	Sov.
Dec-16	0	0	0	0	16	4	0	3	0	6	16	12	126	10	0	0	0
Jan-17	0	0	0	1	0	4	0	0	21	13	21	17	186	29	28	5	0
Feb-17	0	0	0	0	36	4	0	1	0	6	36	11	146	29	0	1	0
Mar-17	0	1	0	1	8	5	0	0	0	15	8	21	125	21	0	4	13
Apr-17	1	0	0	0	17	6	0	0	0	12	18	19	213	17	0	0	78
May-17	0	0	0	2	26	4	0	1	22	2	48	9	163	30	0	5	0
Jun-17	0	1	0	2	24	4	0	2	0	9	24	18	120	19	0	3	19
Jul-17	6	0	0	1	0	0	0	0	20	4	26	5	175	9	0	1	0
Aug-17	0	0	0	0	35	0	0	0	0	1	35	1	157	24	7	1	10
Sep-17	0	0	0	0	16	3	0	0	0	3	16	6	118	18	31	2	0
Oct-17	0	0	6	1	13	3	8	0	21	9	48	13	159	12	0	1	0
Nov-17	0	0	0	0	38	6	0	0	0	2	38	8	145	22	16	1	22
Dec-17	0	0	0	0	0	1	0	0	0	4	0	5	116	21	0	2	0
Total	7	3	6	7	228	43	8	6	84	85	333	144	1949	262	82	27	142

* Marketable bonds include: conventionals, linkers, floaters zero coupons and international bonds.

** Maturities in all currencies and jurisdictions and include secured, unsecured and securitised issuance, including MTNs but excluding short-term (maturity of less than one year) and self-funded deals (deals where there is only one bookrunner and it is also the issuer). The data also include any government guaranteed issuance by the banks but no direct issuance by government or government sponsored institutions.

*** Austria, Belgium, Finland, France, Germany and Netherlands.

**** Greece, Ireland, Italy, Portugal, Spain.

Source: J. P. Morgan, Dealogic

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Event risk calendar

Month	Date	Country	Event
Sep 2017	**24**	Germany	General election
	27	Thailand	BoT rate announcement
	28	New Zealand	RBNZ rate announcement
Oct 2017	**1-4**	United Kingdom	UK Conservative Party Conference
	3	Australia	RBA rate announcement
	3	New Zealand	GDT dairy auction
	4	Poland	NBP rate announcement
	13-15		Annual World Bank/IMF Meetings in D.C.
	17	New Zealand	GDT dairy auction
	24	Hungary	NBH rate announcement
	25	Brazil	BCB rate announcement
	25	Canada	BoC rate announcement
	26	Euro area	ECB rate announcement
	26	Norway	Norges Bank rate announcement
	31	Japan	BoJ rate announcement
Nov 2017		China	19th National Congress
	1	United States	FOMC rate announcement
	2	United Kingdom	BoE rate announcement
	7	Australia	RBA rate announcement
	8	Poland	NBP rate announcement
	8	Thailand	BoT rate announcement
	9	New Zealand	RBNZ rate announcement
	21	Hungary	NBH rate announcement
	23	South Africa	SARB rate announcement
	30	OPEC	OPEC meeting
Dec 2017	**5**	Australia	RBA rate announcement
	5	Poland	NBP rate announcement
	6	Brazil	BCB rate announcement
	6	Canada	BoC rate announcement
	13	United States	FOMC rate announcement
	14	Euro area	ECB rate announcement
	14	Norway	Norges Bank rate announcement
	14	Switzerland	SNB rate announcement
	14	United Kingdom	BoE rate announcement
	19	Hungary	NBH rate announcement
	20	Thailand	BoT rate announcement
	21	Japan	BoJ rate announcement
June 2018	**11**	France	Second round of Parliamentary election

* Not confirmed

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Fact sheet / Sovereign ratings

Fact sheet

	GDP (€bn) 2017	GDP growth (oya, %) 2017	Inflation* (oya, %) 2017	Budget balance (% of GDP) 2017	Prim. Balance (% of GDP) 2017	Gross debt (% of GDP) 2017	Curr. acc. bal. (% of GDP) 2017	GDPpc (EU15=100) 2017	Unempl. rate (%) Latest
Austria	360	1.7	1.8	-1.3	0.7	83	2.0	124	5.4
Belgium	436	1.5	2.3	-1.9	0.7	106	1.5	114	6.8
Cyprus	19	2.5	1.2	0.2	2.6	103	5.9	65	10.8
Finland	218	1.3	1.0	-2.2	-1.1	66	1.8	117	8.8
France	2,275	1.4	1.4	-3.0	-1.2	96	2.4	101	9.2
Germany	3,228	1.6	1.7	0.5	1.7	66	8.0	115	5.7
Greece	182	2.1	1.2	-1.2	2.0	179	0.5	50	23.3
Ireland	280	4.0	0.6	-0.5	1.6	74	4.8	175	6.4
Italy	1,701	0.9	1.5	-2.2	1.7	133	1.9	83	11.6
Netherlands	718	2.1	1.6	0.5	1.5	60	7.4	123	4.8
Portugal	191	1.8	1.4	-1.8	2.4	129	0.5	55	9.1
Slovenia	42	3.3	1.5	-1.4	1.6	78	6.2	60	10.8
Spain	1,157	2.8	2.0	-3.2	-0.6	99	1.6	74	17.1
GDP-weighted avg	10,807	1.7	1.6	-1.4	0.7	91	4.2	103	0.0
US	19,336	2.2	2.2	-4.7^^	-1.0^^	108^^	-2.8	-	4.4
UK	2,005	1.8	2.6	-3.0	-0.5	89	-3.9	-	4.4
Japan	545	1.2	0.4	-4.2	-2.2	239	4.1	-	2.8
Australia	1,798	2.7	2.0	-2.0	11.0	33	-2.6	-	5.6
New Zealand	275	3.0	1.6	0.3	25.0	46	-4.7	-	4.8
Norway	3,218	1.4	2.3	3.2	0.8	28	7.6	-	2.7
Sweden	4,595	2.6	1.4	0.4	0.9	39	5.2	-	6.6
Switzerland	662	1.5	0.0	-0.3	-0.1	35	12.6	-	3.0

Source: EC European Economic Forecast – Spring 2017, IMF, Eurostat, National Central Banks, ILO, BLS, CBO, ABS, Stats NZ, J.P.Morgan

Sovereign ratings

	S&P		Moody's		Fitch		DBRS
Austria	AA+		Aa1		AA+		AAA
Belgium	AA		Aa3		AA-		AA high
Cyprus	BB+		Ba3	POS	BB-	POS	BB low
Finland	AA+		Aa1		AA+		AA high
France	AA		Aa2		AA		AAA
Germany	AAA		Aaa		AAA		AAA
Greece	B-	POS	Caa2	POS	B-	POS	CCC high
Ireland	A+		A2		A		A high
Italy	BBB-		Baa2	NEG	BBB		BBB high
Netherlands	AAA		Aaa		AAA		AAA
Portugal	BBB-		Ba1	POS	BB+	POS	BBB low
Slovenia	A+		Baa1		A-		-
Spain	BBB+	POS	Baa2		BBB+	POS	A low
US	AA+		Aaa		AAA		AAA
UK	AA	NEG	Aa1	NEG	AA	NEG	AAA
Japan	A+		A1		A		A
Australia	AAA	NEG	Aaa		AAA		AAA
New Zealand	AA+		Aaa		AA+		-
Sweden	AAA		Aaa		AAA		AAA
Norway	AAA		Aaa		AAA		AAA
Switzerland	AAA		Aaa		AAA		AAA

Notes: Grey highlight represents below IG; "*" represents under watch. NEG - negative outlook, POS – positive outlook, DEV - developing outlook, blank represents stable outlook. Rules for a country to be included in an IG index are as follows: *1)* J.P. Morgan's EMU IG index: Rated IG by Moody's, S&P and Fitch; *2)* Bloomberg Barclays AGG: Rated IG using middle rating of Moody's, S&P, and Fitch; *3)* Citi WGBI: minimum credit quality of A-/A3 by either S&P or Moody's for all issuers; *4)* Markit iBoxx: Rated IG by Moody's, S&P and Fitch.
Source: S&P , Moody's, Fitch, DBRS and Bloomberg

Eurozone rating action calendar

	AT	BE	CY	FI	FR	GE	GR	IE	IT	NL	PO	SL	SP	UK
22-Sep-17														M↓
29-Sep-17					D								S↑	
06-Oct-17	D				S				M↓				D	
13-Oct-17					M		M↑							
20-Oct-17	M		F↑			M			F		D		M	
27-Oct-17				M		S			S	M, F				S↓, F↓
03-Nov-17		M												
10-Nov-17							D							
17-Nov-17			M↑							S				
24-Nov-17														

Legend: "S": S&P, "M": Moody's, "F": Fitch, "D": DBRS, "↓" - negative outlook, "↑" – positive outlook; "*" – under watch
Source: S&P , Moody's, Fitch, DBRS

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Global Market Movers

25 Sep	26 Sep	27 Sep	28 Sep	29 Sep
Euro Area ECB's Draghi, Mersch, Constâncio and Mersch speak in Brussels, Lisbon, Frankfurt and Frankfurt respectively **Germany** IFO bus. survey (10:00am) Sep **United Kingdom** CBI financial services sector survey (12:01am) 2Q **United States** Dallas Fed manufacturing (10:30am) Sep Chicago Fed President Evans speaks on economy and monetary policy (12:40pm) Minneapolis Fed President Kashkari speaks in Grand Forks, North Dakota (6:30pm) **Japan** PMI manufacturing prelim (9:30am) Sep 52.5 BoJ governor Kuroda's speech at a meeting with business leaders in Osaka (2:35pm)	**France** INSEE bus. conf. (8:45am) Sep **United Kingdom** BBA Mortgage lending (9:30am) Aug **United States** Philadelphia Fed nonmanufacturing (8:30am) Sep S&P/Case-Shiller HPI (9:00am) Jul New home sales (10:00am) Aug Consumer confidence (10:00am) Sep Richmond Fed survey (10:00am) Sep Dallas Fed services (10:30am) Sep Clev. Fed President Mester moderates NABE conference session (9:30am) Fed Chair Yellen delivers Keynote at NABE conference (12:00pm) Atlanta Fed President Bostic speaks to the Atlanta Press Club (12:30pm) **Japan** Corporate service prices (8:50am) Aug 0.7%oya Minutes of the Jul 19-20 BoJ Monetary Policy Meeting (8:50am) **Sweden** PPI (9:30am) Aug **New Zealand** Trade balance (10:45am) Aug -NZ$0.5bn NBNZ business confidence Sep 20.0	**Euro area** M3 (10:00am) Aug **France** INSEE cons. conf. (8:45am) Sep **Italy** ISAE bus. conf. (10:00am) Sep ISAE cons. conf. (10:00am) Sep **United Kingdom** CBI distributive trades (11:00am) Sep **United States** Durable goods (8:30am) Aug Pending home sales (10:00am) Aug St. Louis Fed President Bullard speaks on economy and monetary policy (1:30pm) Boston Fed President Rosengren speaks in New York (5:30pm) **Japan** Shoko Chukin small firm survey (2:00pm) Sep 49.6, sa **Sweden** Consumer confidence (9:00am) Sep Economic Tendency survey (9:00am) Sep Household lending (9:30am) Aug Trade balance (9:30am) Aug **Norway** AKU unemployment (8:00am) Jul	**Euro area** EC cons. conf. (11:00am) Sep EC econ. sent. (11:00am) Sep ECB's Praet and Lautenschläger speak in Berlin and Vienna respectively **Germany** Import price index (8:00am) Aug GfK cons. conf. (8:00am) Oct CPI 6 states and prelim (2:00pm) Sep **Spain** CPI prelim (9:00am) Sep **Belgium** CPI (8:00am) Sep **Netherlands** CBS bus. conf. (6:30am) Sep **United Kingdom** EC consumer confidence (10:00am) Sep **United States** Initial claims (8:30am) w/e Sep 23 Real GDP (8:30am) 2Q final Advance economic indicators (8:30am) Aug KC Fed survey (11:00am) Sep **Japan** BoJ governor Kuroda's speech at the National Securities Industry Convention in Tokyo (3:35pm) **Sweden** Retail sales (9:30am) Aug **Norway** Credit indicator growth (8:00am) Aug **New Zealand** RBNZ official rate announcement No change	**Euro area** HICP flash (11:00am) Sep ECB's Draghi participates in event at Bank of England **Germany** Retail sales (8:00am) Aug Employment (9:55am) Sep Unemployment (9:55am) Sep **France** Cons. of mfg goods (8:45am) Aug CPI prelim (8:45am) Sep PPI (8:45am) Aug **Italy** CPI prelim (11:00am) Sep PPI (12:00pm) Aug **United Kingdom** Gfk cons. conf. (12:01am) Sep Lloyds business barometer (12:01) Sep BoP (9:30am) 2Q Business investment final (9:30am) 2Q Index of services (9:30am) Jul M4 & M4 lending final (9:30am) Aug Net lending to indiv. (9:30am) Aug Real GDP final (9:30am) 2Q **United States** Personal income (8:30am) Aug Chicago PMI (9:45am) Sep Consumer sentiment (10:00am) Sep final **Japan** All household spending (8:30am) Aug -1.8%oya Job offers to applicants ratio (8:30am) Aug 1.52 Nationwide core CPI (8:30am) Aug 0.7%oya Unemployment rate (8:30am) Aug 2.8% IP (8:50am) Aug 2.0%m/m, sa Total retail sales (8:50am) Aug 0.5%oya Housing starts (2:00pm) Aug -2.5%oya Summary of Opinions at Sept 20-21 BoJ Monetary Policy Meeting **Sweden** Wage stats (9:30am) Jul **Norway** Retail sales (8:00am) Aug Labor directorate unemployment (10:00am) Sep **Australia** Pvt. sector credit (11:30am) Aug 0.4%m/m **New Zealand** Building permits (10:45am) Aug **China** PMI Mfg. (9:45am) Sep 51.3

02 Oct	03 Oct	04 Oct	05 Oct	06 Oct
Euro area PMI mfg (10:00am) Sep Unemployment rate (11:00am) Aug **Germany** PMI mfg (9:55am) Sep **France** PMI mfg (9:50am) Sep **Italy** PMI mfg (9:45am) Sep **Spain** PMI mfg (9:15am) Sep **United Kingdom** PMI Mfg (9:30am) Sep **United States** Manufacturing PMI (9:45am) Sep final ISM manufacturing (10:00am) Sep Construction spending (10:00am) Aug Dallas Fed President Kaplan speaks in El Paso (2:00pm) **Japan** BoJ Tankan (8:50am) 3Q PMI manufacturing final (9:30am) Sep Auto registrations (2:00pm) Sep **Sweden** PMI (8:30am) Sep **Norway** PMI Mfg (9:00am) House prices (9:00am) 3Q *Holiday: China*	**Euro area** PPI (11:00am) Aug **United Kingdom** PMI Construction (9:30am) Sep FPC minutes **United States** Light vehicle sales Sep **Japan** Consumer sentiment (2:00pm) Sep **Australia** ANZ job advertisements (11:30am) Sep Building approvals (11:30am) Aug RBA official rate announcement (2:30pm) *Holiday: China*	**Euro area** MFI interest rates (10:00 am) Aug PMI serv. & comp (10:00am) Sep Retail sales (11:00am) Aug **Germany** PMI serv. & comp (9:55am) Sep **France** PMI serv. & comp (9:50am) Sep **Italy** PMI serv. & comp (9:45am) Sep **Spain** PMI serv. & comp (9:15am) Sep **United Kingdom** PMI Services (9:30am) Sep **United States** ADP employment (8:15am) Sep Services PMI (9:45am) Sep final ISM nonmanufacturing (10:00am) Sep Fed Chair Yellen speaks on community banking (3:15pm) **Japan** PMI services (9:30am) Sep **Sweden** PMI Services (8:30am) Sep **New Zealand** ANZ commodity price (1:00pm) Sep *Holiday: China*	**Euro area** ECB minutes (1:30pm) **Netherlands** CPI (6:30am) Sep **United Kingdom** New car regs (9:00am) Sep BoE HEW (9:30am) 2Q **United States** Initial claims (8:30am) w/e Sep 30 International trade (8:30am) Aug Factory orders (10:00am) Aug **Sweden** IP & orders (9:30am) Aug Services production (9:30am) Aug **Australia** Retail sales (11:30am) Aug Trade balance (11:30am) Aug *Holiday: China*	**Germany** Mfg orders (8:00am) Aug **France** Foreign trade (8:45am) Aug Monthly budget situation (8:45am) Aug **United Kingdom** Halifax HPI (8:30am) Sep Quoted mortgage interest rate (9:30am) Sep **United States** Employment (8:30am) Sep Wholesale trade (10:00am) Aug Consumer credit (3:00pm) Aug Dallas Fed President Kaplan speaks (12:45pm) **Japan** Employer's survey prelim (9:00pm) Aug **Sweden** Budget Balance (9:30am) Sep **Norway** IP Mfg (8:00am) Aug *Holiday: China*

Selective list as of 22 September 2017. Forecasts are m/m, nsa, unless stated & times are local. Telephone your J.P. Morgan representative for an update/more details.
Highlighted data are scheduled for release on or after the date shown. Times shown are local.